STOCKS DOWN UNDER

14 AUGUST 2020

Stocks Down Under

“Silver, gold - I don’t discriminate! I like sparkly things.”

- Charlaine Harris (b. 1951), American author

NORTHERN STAR RESOURCES

Proven Performer, but is it too expensive?

BLACKWALL PROPERTY TRUST

Putting the trust back in property

RICEGROWERS

Dine out on this one

MESOBLAST REVISITED

Judgement Day, but not terminated

NORTHERN STAR RESOURCES

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Stocks Down Under rating: ★★★

ASX: NST
Market cap: A$ 10.7BN
Dividend yield: 1%

52-week range: A$8.85 / A$16.77
Share price: A$ 14.13

With gold going through US$2,000 per ounce recently, it is hard to go past Northern Star Resources. This is one of Australia's largest gold producers, with a strong track record of growth and expecting to produce one million ounces of gold in FY21. However, with a revision of its guidance, deferral of both its half year dividend and current hedge book deliveries, is it overpriced? We believe the P/E ratio of 32x and dividend yield of 1% on forecast FY21 is telling you something.

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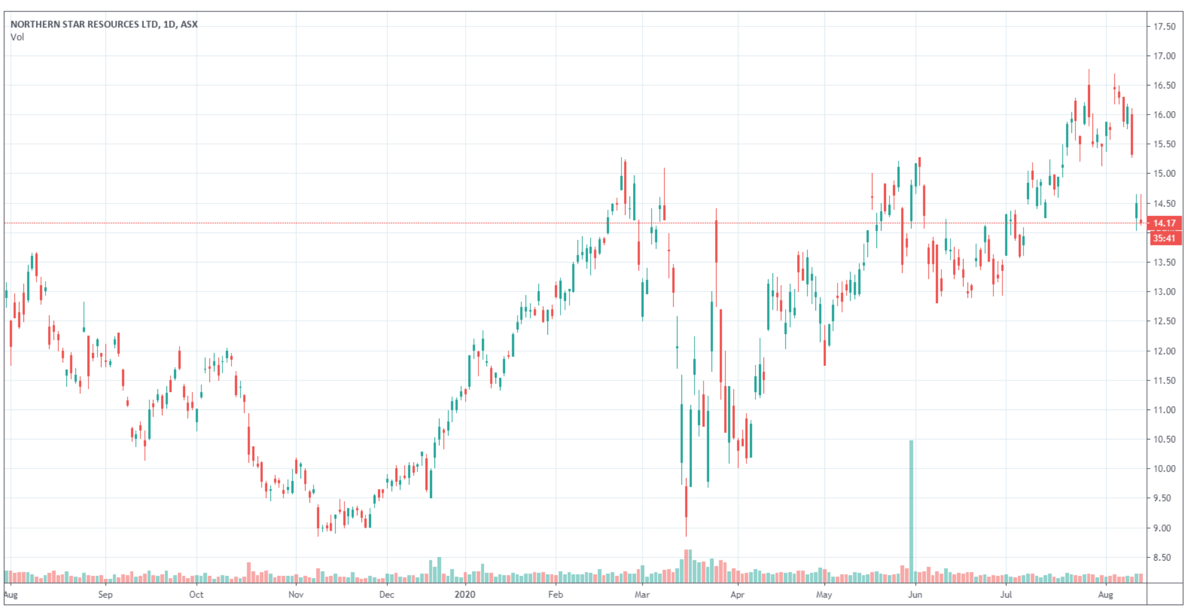
Share price chart



Source: Tradingview

From explorer to tier-one producer

When Northern Star Resources was listed on the ASX in December 2003 it was just another Western Australian mineral explorer. In 2010, it changed strategy and started acquiring late stage projects that were either close to producing or actually in production. The current Board and most of the management have driven this stock from $10m to the current $11bn-or-so market capitalisation.

During this time Northern Star has acquired assets from Barrick, Newmont and last year acquired a large gold project in Alaska. This asset has commenced production and should produce 200,000 ounces in FY21. The strategy has always been to finance acquisitions with debt and current cashflows. However, we believe that in current economic conditions the company may be taking on too much risk to continue acquiring projects under this strategy. It may be more beneficial to focus on growing organically to one million ounces per year rather than take excessive risks buying growth. Excess cashflow could be used to pay dividends to shareholders.

On course for one million ounces per year

This company, which now has over 22 million in resources and 8 million in reserves, produced 900,000 ounces of gold in FY20 throughout its four production areas. Looking forward to FY21, Kalgoorlie should deliver 340,000 – 380,000 ounces at an All in Sustaining Cost ("AISC") of A$1,260 - A$1,370 per ounce. Notice that's Australian dollars we just quoted. If gold is $2,000 American dollars that's about $2,790 of ours. So Northern Star is notionally sitting pretty.

Think about it. The legendary Kalgoorlie Super Pit, in which the company has a 50% interest, should deliver 120,000 –140,000 ounces in FY21 at an AISC of A$1450 - A$1550. Another WA mine, Jundee, will do 260,000 – 280,000 ounces at an AISC of A$1,115 - A$1195 and Pogo in Alaska 200,000 – 240,000 ounces at AISC of A$1,200 - A$1320. Add it all up and Northern Star should produces at A$1,235 per ounce, which is a margin of A$1,600 per ounce at the current gold price. Should the gold price stay where's its been lately, that margin translates into more than A$1bn in cashflow.

Mind you, the Pogo Gold Mine in Alaska has just started production and one needs to be careful to consider any capital expenditure blowouts as well as the need for management with local knowledge.

Bets need to get re-hedged

Now, here's the problem – Northern Star has a hedge book of about 540,000 ounces where it is contracted to deliver at A$2,085. That's Australian dollars, way below the current Australian dollar gold price, where it effectively loses A$800 per ounce. That's A$430m. To reduce the size of this hedge book, the company has delivered 170,000 ounces last quarter. The company has also deferred any more repayments until 2021. With the gold price in whatever currency you choose expected to move higher over the next few years, we would have thought it would be prudent to pay it off ASAP. It is important to note that the company is not losing money, but is just losing the opportunity of making more.

To put this into context, the current hedgebook is only half a year's production. If the gold price was to fall, the company has locked in a forward price. However, should the gold price go to US$3,000 (which is A$4,000), then at current levels the hedgebook would have an unrealised loss of over A$1bn.

Following the outbreak of COVID-19 and operations running at a reduced capacity, the company deferred its half-year dividend of 7.5 cents per share until after the financial close of FY20 and has removed production and cost guidance. This can be a worrying sign for investors as uncertainty breathes danger. In an everchanging market, transparency is vital.

Having said all that, the end is not nigh for Northern Star. This company has net cash of A$70m with cash and gold on hand of A$770m and bank debt of A$700m.

There's a lot of investment funds weighing into gold

With interest rates being close to zero, international investors have been flocking to gold as a safe haven. Benefeciaries of these funds have been ETF and institutions buying into quality company's such as Northstar Resources. Investors need to be wary that stocks like Northstar Resources are having excess liquidity as a result. However, they also needs to be aware that should the gold price fall away, investors will liquidate these holdings just as quickly as they made them.

Whilst Northstar Resources has a proven track record, great management and first class gold assets, issues such as hedgebook, potential future project cost blowouts and the size of bank debt need to be factored into the valuation and we believe one should not just look at leverage to the gold price. Three stars from us.

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Share price chart

Source: Tradingview

Time was when Australians didn't eat rice and got all their carbohydrates from potatoes. Then in the 1970s more and more Asian people started moving here and the country more or less 'discovered' rice. That was great for a whole lot of farmers in the Riverina, that area of rich farmland in southwestern NSW dominated by the Murrumbidgee river and its cousin, the mighty Murray. The climate down there is ideal for rice growing and, ultimately, it was great for Ricegrowers, which started out in the 1950s as a ricegrower's co-operative and evolved into a major global rice supplier over the years and, importantly, a producer of all sorts of branded, rice-based products.

There's rice and then there's rice food

The thing about rice as a grain is that it lends itself to a long cavalcade of really tasty and interesting foods that consumers will pay a premium for. And not just because rice comes in basic varieties such as basmati, jasmine, 'sticky' and so on. We mean all the food product you can make from those varieties. Just walk into your local Woolworths and you'll see what we mean. If you don't fancy the 250 gram pack of the gluten-free brown rice and quinoa that was $3.49 but is now on special at $2.80, you might like the 150 gram brown rice chips with sea salt at $2.50, or the 195 grams of rice cake with sundried tomato and basil at $2.00. All three of those products come with the distinct red, yellow and white SunRice logo that Australians have been getting used to ever since the Rice Granny started showing up in television ads to pitch the products back about 1980.

Innovation in rice-based food has turned Ricegrowers into a serious food company worthy of investor attention today. Sure, the company hasn't exactly been enjoying the fruits of its R&D and M&A labours lately - in the year to 30 April, NPAT was down 31% at only $22.7m. However, the decrease would have been a lot less if the company hadn't had to spend money managing its COVID-19 risk and if the drought in Australia hadn't impacted sales of CopRice-branded stockfeed products. We think the earnings from the core foods businesses will continue to grow over time because rice has become such an important part of diets right around the world, not just in Asia, and Ricegrowers has been investing heavily in these businesses in recent years as a '2022 Growth Strategy'.

A misunderstood company

The trouble with Ricegrowers from an investor perspective right now is twofold. One problem is the price of rice on world markets. Back in mid-2016 Rough Rice was changing hands on the Chicago Board of Trade at only US$9 per CWT (that is a 'hundredweight, which is about 50.8 kg). In May 2020 it got to US$17 per CWT, basically because of concerns that supply chains would be deranged by COVID-19 and panic buying on the part of consumers. Because a lot of what Ricegrowers does is buy, sell and transport rice for food makers, the belief is that earnings rises and falls with the price of rice. So with Rough Rice now back at more like US$11 a CWT, Ricegrowers stock has eased as well. We think once investors figure out that raw rice is really just a business input and not the business itself, the price of rice will cease to be such an influence on Ricegrowers' share price.

The second problem SunRice has when it comes to investors is its structure. As a former co-operative, it's ownership is split. Growers own the A Class stock and we investors only get access to the B Class stock, which trades on ASX as SGLLV. A Class stock gets cash flows from the Rice Pool that is operated on the part of growers and was basically Ricegrowers' foundation business. B Class gets the actual commercial upside from the food business. The perception on the part of some investors is that this company would be run for the benefit of the A Class shareholders. Actually it's the other way around because the Pool has to pay for the rights to the SunRice brand and other SunRice assets, which benefits the B Class shares.

Currently, that SunRice B class stock is trading on ASX at an EV/EBITDA multiple of just 5x FY22 earnings, where EBITDA in the year to April 2022 is expected to be around 25% greater than the year just past. We attribute this low multiple to investors not really understanding what the company is growing from, but we also think that misunderstanding will change over time. So, the Michelin rating from us for this quality rice restaurant is four stars.

BLACKWALL PROPERTY TRUST

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Share price chart

Source: Tradingview

Don't just sit on your money, improve your assets

If one thing was made clear by reading BWR's 1HY20 report it was the long-term view management takes to acquisitions, investments and the Australian property market. Management made it clear, while they were keeping an eye out for potential purchases, that yields offered by Australian properties were currently too low for purchase, especially on the East Coast. Therefore, management is using BWR's capital to improve the properties already in its portfolio and, as of the 24 July announcement, acquire WOTSO in a combined acquisition and restructuring into a stapled security. With BWR's current property portfolio yielding an average of 7.3% at the end of 1HY20, improving the value of their property through improvements and expansions seems like a smart strategy. We believe this shows a strong understanding of their businesses on the part of management and bodes well for future performance.

By taking advantage of cheap interest rates in order to improve upon its properties in a sensible way, BWR is adding shareholder value irrespective of market conditions. Take two recent examples: BWR redeveloped and extended the ground floor of their Varsity Lakes, Qld property adding a childcare centre and reconfigured the lobby of their Symonston property in Canberra, including the addition of a café.

BWR strong but not unscathed

COVID-19 has had an impact across Australia and especially on properties as landlords have been forced to offer rent abatements and deferrals due to the early lockdowns imposed across the country. While BWR has certainly not been immune to this situation, their property positioning puts them at an advantage, in our opinion. With no exposure to Victoria, a quick recovery from their main tenant, WOTSO, and low total liabilities/total assets of 20.9% (1HY20), BWR should continue to offer solid value and growth, while being able to pounce on any opportunities.

Insider acquisition of shares, especially during a crisis like COVID-19, is always a bullish signal. Across nine periods between 14 April 2020 and 5 August 2020, BWR's Non-Executive Chairman Seph Glew increased his position by around 1.1 million shares at an average cost of $1.32 per share. As of 12 August Seph has purchased approximately 0.69% of outstanding shares during, what would be considered the height, of COVID-19 in BWR's property regions.

WOTSO acquisition is a natural extension of BWR's portfolio

WOTSO is a company that provides shared workspace on a rental basis and is, by far, BWR's largest tenant. In 8 out of 11 of BWR's properties WOTSO is listed as a major tenant. While BWR owns the properties in its portfolio, BlackWall Limited (ASX:BWF), its listed sister company, manages the properties and in January 2020 demerged WOTSO. This made WOTSO a non-listed public company and therefore, we can have a better understanding of how COVID-19 has affected BWR's largest tenant. In February, WOTSO offered its clients the opportunity to suspend their contracts but still reserve their desks. Out of their 3,600 occupied desks in February 2020, 2,400 were either suspended or cancelled due to COVID-19. However, mainly due to WOTSO's lack of exposure to Victoria, by 1 July some 1,450 desks had been reactivated and 500 new desks had been signed up, for a total of 3,150 currently occupied desks. WOTSO has provided guidance that they should be back to approximately 3,600 occupied desks by the end of 2020.

Despite COVID-19, WOTSO's turnover (receipts from customers, franchises and joint ventures) has increased over the last three years, from $7.8m in FY18, to $10.9m in FY19, to $12.8m in FY20. With solid growth and, excluding any major resurgence of COVID-19 outside of Victoria, WOTSO's management believes they have a solid positioning in the coming years as more companies look for flexible work arrangements. Additionally, WOTSO's management is supportive of being acquired by BWR in order to form a stapled security. Which, pending approval from shareholders and the courts, would likely close in early 2021.

Solid dividend, solid assets, low continuing exposure to COVID a recipe for success

As of 1HY20, BWR's NTA per unit increased to $1.56 a share, which is a 5.4% increase. Utilising BWR's closing price on 12 August 2020, the stock is trading at an approximate 15% discount to NTA. BWR believes this to be too cheap and started buy-backs last October, the latest filling being on 23 June 2020 with the highest price paid being $1.42.

We agree with BWR's management that a discount of 15% is too high and therefore, it deserves a four star rating from us.

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Share price chart

Source: Tradingview

One of Stocks Down Under's editors has been following the biotechnology industry as an equities analyst since 2002. He likes to joke that Don Henley wrote his 1989 hit 'New York Minute' about biotech stocks: 'Everything can change / In a New York Minute / Things can get a little strange / In a New York Minute'. The chorus of Don's song is particularly relevant to Mesoblast right now.

A literal New York moment

Mesoblast's literal New York Minute, as we noted on 30 July, was the 24 April 2020 data, gained in patients at New York's Mount Sinai Hospital, showing that COVID-infected patients with Acute Respiratory Distress Syndrome could come off their ventilators much more quickly if they received Mesoblast's Remestemcel-L product. That news was good enough to take Mesoblast stock from under $2.00 to about $3.85 in just two days.

Mesoblast's second New York Minute of 2020 happened on 11 August, although it might be more apposite to call it a Washington Minute. This time Mesoblast stock went the other way to its 24 April re-rating and the issue was what the FDA, which regulates the American pharmaceutical industry, intends to do with Remestemcel-L's first indication. As we noted on 30 July, Remestemcel-L has been shown to have clinical benefit in a rare disorder called Graft-Versus-Host-Disease, or GvHD for short. GvHD is where a bone marrow transplant causes a severe immune reaction in the recipient because the donor and the recipient have a different genetic makeup. In Phase 3 Mesoblast was able to show that in paediatric patients suffering severe GvHD, where steroids hadn't tackled the inflammation, Remestemcel-L is able to keep those patients alive. Sounds great, right?

Defending its thesis

Well, yes and no. You see, before a drug can gain FDA approval the drug's developer generally has to go before an FDA Advisory Committee, where a panel of experts give their view on the drug and vote on whether or not it should be approved. Think of it as not unlike a defence of a PhD thesis where the learned professors are out to see if the PhD candidate really has done the work to get awarded his or her doctorate. In this case it's not the Advisory Committee approving or rejecting the drug – that's the job of the Agency itself. The FDA, however, generally follows the advice of its Advisory Committee.

The reason Mesoblast stock crashed on 11 August was that, the FDA being a US government agency, the briefing documents for the Advisory Committee meeting are public domain material. Parts of those documents are critical of the data related to Remestemcel-L and GvHD. Basically what the critics are saying is that this drugs works, in that the key Phase 3 trial hit its 'primary endpoint' where 69% of the treated patients responded to the drug compared to only 45% in the controls. That doesn't mean, say the critics, that it should be approved because, for example, we don't know if the response is durable because it was only a 28-day response. Or maybe Remestemcel-L doesn't really contribute to survival on the part of patients, because the numbers in the study were too small to tell for sure, statistically speaking.

What to make of this? Well, they're just briefing documents. It doesn't make it a certainty that the Advisory Committee will vote against the drug after the 13 August meeting, which goes all day Washington time, meaning it will be Saturday in Australia before it's over. If the Advisory Committee says no it may be bad for Mesoblast stock but only because the Agency will likely ask for more data before approving it.

It's more of a timing issue than anything. Meantime there's plenty more data coming for this company, including the COVID-19 data. That's why we're sticking with Four Stars. But, as Don Henley once sang, In a New York Minute / Things can get a little strange.

Pitt Street Research Pty Ltd

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