STOCKS DOWN UNDER

3 SEPTEMBER 2020

Stocks Down Under

"There are three things extremely hard: steel, a diamond, and to know one's self."

- Benjamin Franklin (1706-1790), American statesman

BLUESCOPE STEEL

Gold is not the only metal of fortune

FLEXIGROUP

The changling of the Buy Now Pay Later industry

WARREGO ENERGY

Helping the Perth Basin realise its potential

BLUESCOPE STEEL

Gold is not the only metal of fortune

Stocks Down Under rating: ★★★★

ASX: BSL
Market cap: A$ 6.258BN
Dividend yield: 1.1%

52-week range: A$8.03 / A$16.17
Share price: A$ 13.10

BlueScope Steel is a global finished and unfinished steel producer headquartered in Melbourne. While the majority of BlueScope Steel's business revolves around the production and sale of finished and unfinished steel, the company also operates a small subsidiary that builds and develops non-residential properties in North America. Steel has been a significant news point over the last five-years featuring Chinese dumping, tariffs by the United States, Australian anti-dumping investigations against China and the global infrastructure boom. Despite these macroeconomic risks, we believe BlueScope Steel proves that gold is not the only metal of fortune.

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Stocks Down Under rating: ★★★

ASX: FXL
Market cap: A$ 445.6M

52-week range: A$0.38 / A$2.71
Share price: A$ 1.11

FlexiGroup is a rather unique addition to the Buy Now Pay Later sphere for three main reasons: the number of different product types; Bundll; and the fact that the company is almost 30-years old. While the number of active customers, retail and commercial partners, and transaction volume has been on the rise, FlexiGroup saw a disappointing statutory net profit after tax year-over-year decline of 65%. However, Flexigroup remains profitable and the company's current consolidation and expansion initiatives create a hopeful view of the future.

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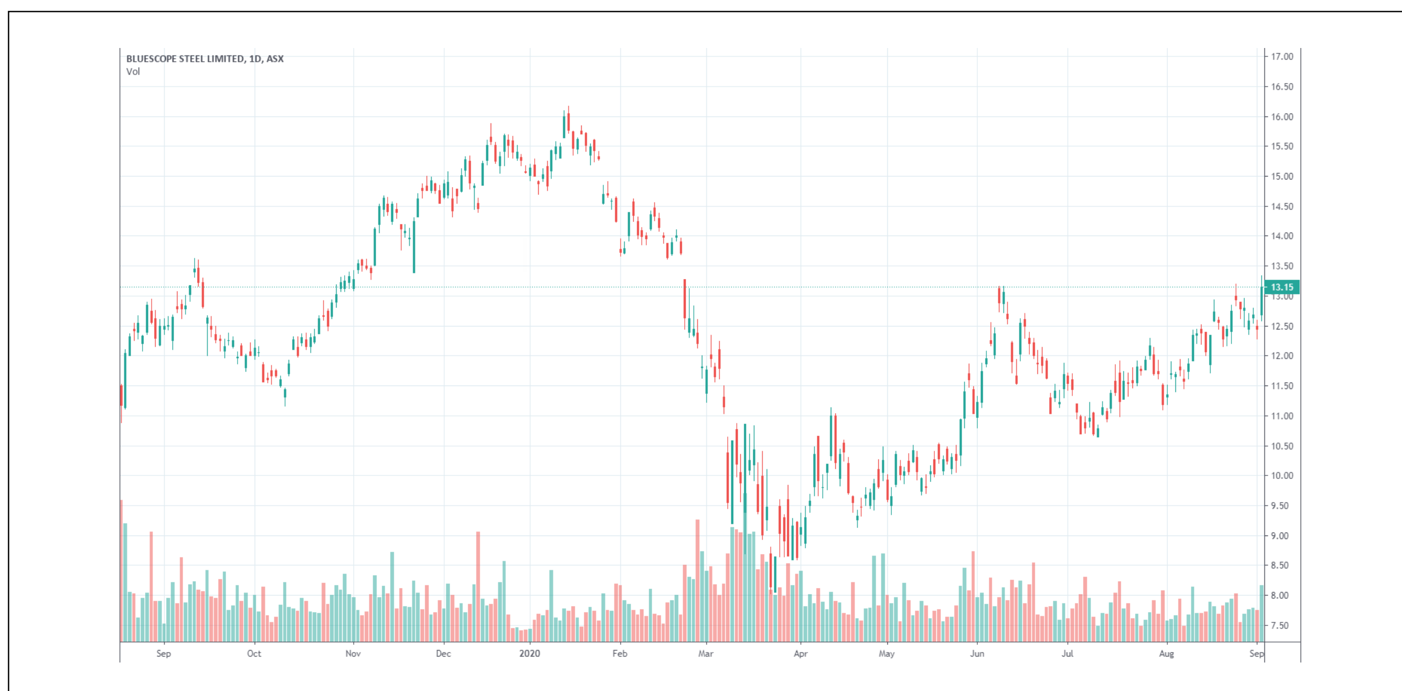
Share price chart



Source: Tradingview

Six subsidiaries, six vertical integrations

BlueScope Steel operates globally through six main subsidiaries: Australia Steel Products; North Star; Building Products Asia and North America; Buildings North America; and New Zealand and Pacific Islands. Across these six subsidiaries the company produces finished and unfinished steel products and also constructs non-residential buildings.

Australia Steel Products is Bluescope's high value coated and painted flat steel products business, although it does make some commodity flat steel. As the name implies, the majority of Australia Steel Products are sold for domestic consumption however, a small portion of the products are exported. Underlying earnings before interest and taxes for this business segment in FY20 was $305.1m, a decline of 43% year-over-year. The reason for the decline was weaker regional prices and the sharp increase in the price of iron ore crunching margins combined with a 6% decline in year-over-year volumes.

North Star is a single site producer of hot rolled coil steel in Ohio, USA. North Star is currently subject to a significant expansion starting in FY20. Management has issued guidance that there is a remaining cost of between US$375m to US$450m to be spent during FY21. The sale mix for North Star is 90% based in the midwestern USA of which approximately 50% automotive, 35% construction, 10% manufacturing and industrial, and 5% agricultural. Despite North Star's overwhelming reliance on the automotive industry of the United States, which was shut down for approximately two months during FY20, for 2HY20 the plant operated consistently at over 90% capacity. However, weaker steel spreads caused a 71% decline in underlying year-over-year EBIT to $189.6m.

Building Products Asia and North America produces finished steel metal coated and painted building products which it mainly sells to the construction industry. The business in North America and the ASEAN (Association of Southeast Asian Nations) countries is operated through a 50/50 joint venture with Nippon Steel, while India is through a 50/50 joint venture with Tata Steel. Sales in China are not operated through a joint venture. A combination of BlueScope Steel's successful cost cutting program and better margins allowed this subsidiary to provide the only year-over-year increase in underlying EBIT of 16% to $155.3m in FY20.

Buildings North America is an unusual subsidiary for BlueScope Steel as instead of producing steel products, this subsidiary builds and develops low-rise, non-residential projects in the US and Canada, specialising in warehouse and distribution centres. However, as the American market has grown softer during 2HY20, underlying EBIT declined 29% year-over-year to $37.9m.

Bluescope's New Zealand and Pacific Islands business is a major steel producer in New Zealand. This subsidiary is in trouble as it was forced to take a massive $197m non-cash write-down during FY20. The write-down is understandable considering the $86.4m year-over-year decline in underlying EBIT, causing an underlying EBIT loss of $5.8m. This is not likely to reverse soon as is evident from the comments of management and the sheer scale of the write-down.

Risk, its more than just the game of global conquest

For the world as a whole FY20 was not without a significant amount of continuing risk however, for the steel industry, that risk was heightened. The steel industry is highly globalised, and its margins require a smooth global supply chain for the transport of iron ore and the finished and unfinished steel products. For this there are two main risks, COVID-19 and economic disruption around the world. Additionally, one of the world's largest steel consumer, India, has experienced the sharpest economic contraction in its history, and there are concerns that India is up for a long, ongoing recession. Lastly, a going risk unique to the steel industry is China resuming its steel dumping. In 2016 the average price of steel crashed over 71% due to Chinese dumping and with increased tensions between the United States, Australia and China, investors need to keep a close eye out for China to potentially take retaliatory action by resuming steel dumping.

Sometimes risk is already baked into the price

Due to the COVID-19 situation, economic uncertainty and geopolitical issues, we don't believe a proper valuation would be off BlueScope Steel's FY21 estimated earnings growth. Investors will need to be patient with this company during FY21 and look towards the future. Therefore, we believe utilising the consensus EBITDA growth estimates for FY22 is more appropriate. Current EBITDA FY22 growth estimates put FY20 through FY22 EBITDA growth at 14.6% or an estimated compound annual growth rate of approximately 7.1%. Meanwhile, BlueScope Steel is currently trading at an estimated FY22 EV/EBITDA of 5.4x and we believe this shows the market has overpriced the risk currently facing BlueScope Steel. Therefore, we are issuing BlueScope Steel a Four Star rating with the caveat that if China resumes dumping steel close to 2016 levels, we would change that rating to Two Stars.

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Share price chart

Source: Tradingview

A FlexiGroup operating segment tearsheet

FlexiGroup currently consists of four main operating segments: Buy Now Pay Later, Australian credit cards, New Zealand credit cards and commercial and leasing. While Net Profit After Tax is a common enough reporting metric, FlexiGroup uses a metric called Cash Net Profit After Tax. The reporting is similar to Net Profit After Tax, however, it adjusts for the material infrequent items that are not indicative of ongoing operations and the amortisation of acquired intangible assets. In other words, COVID-19 one off charges and the amortisation of intangible assets like goodwill are excluded from this metric.

Buy Now Pay Later is currently the second largest driver of FlexiGroup's Cash Net Profit After Tax at 19.5% during FY20 - a sharp decline from the 36.9% recorded during FY19. While the decline was cited by management as mainly due to margin compression, operating expenses and impairment losses were considerably higher as well. This removed any Cash Net Profit After Tax benefit from 18% consumer loan volume growth during FY20. However, it is important to note that during FY20 FlexiGroup launched a new Buy Now Pay Later product called Bundll. The marketing boost from this new product must be considered when analysing the rise of operating expenses.

Flexigroup's New Zealand credit card, the Q Mastercard, has historically been the largest provider of Cash Net Profit After Tax and FY20 was no exception. In fact, volume increased 2% and net income increased 12%, leading to a climb from 36.9% of FY19 Cash Net Profit After Tax to 67.8% during FY20. If not for the COVID-19 macro overlay provision in impairment losses, FY20 would have seen growth around 30% instead of a 29% decline. Despite the shift to Buy Now Pay Later, we believe this business segment will continue to play an important role in cash generation and growth for FlexiGroup.

Flexigroup's Australian credit card, the Skye Mastercard, is consistently the smallest operating segment, declining from 9.9% of FlexiGroup's Cash Net Profit After Tax in FY19 to 5.2% in FY20. While net income increased 6% during FY20, FlexiGroup increased marketing operating expenses by 20%, removing any benefit to the Cash Net Profit After Tax bottom line. However, a concerning note for this segment is the 25% decrease in volume and 21% decline in closing customer loans.

The commercial and leasing operating segment is a prime example of the benefits to come from FlexiGroup's business simplification and consolidation. Due to these measures operating expenses declined 22% year-over-year during FY20 however, net income declined 23% due, in part, to the changing business causing less fees to be collected. This led to a decline from 16.3% of Cash Net Profit After Tax during FY19 to 7.5% during FY20. A point of support for this operating segment is the sharp growth in customer loans of 11% during FY20 and volume growth of 46% year-over-year during 2HY20 as Small and Medium Enterprises looked for funding. This trend we expect to continue through FY21, and look forward to reviewing this operating segment during FlexiGroup's 1HY21 report.

'I can change in an instant but not just for the **** of it' – Bobby Axelrod

FlexiGroup needed a change. The company's focus was all over the place and it operated too many businesses. Therefore, we were pleased that one of the focuses of FY20's annual report was the consolidation, simplification and change of the businesses. FlexiGroup realised annual cost savings of approximately $10m during FY20 with additional, significant, annual cost savings expected to be created during FY21. No less important however, is the drastic improvement in FlexiGroup's efficiency and ability to handle customer service calls and requests due to the adoption of centralised systems, automation, and self-service functions. As FlexiGroup is currently in growth mode, we believe this is an important aspect for the company to get right.

Wait Now and Pay Later

Flexigroup is riskier than its Buy Now Pay Later peers as investors are betting on a turnaround. Therefore, we believe right now is the time to watch and we will revaluate our rating after the company announces its 1HY21 report early next year. Until we see some traction on the transformation and a reversal in the Buy Now Pay Later operating segment, we must stick to a Three Star rating.

While we rate FlexiGroup at Three Stars today, out of an abundance of caution we felt it was important to outline a more bullish case. FlexiGroup is one of the riskier companies in the Buy Now Pay Later space as it is undergoing a significant transformation. However, the initiatives by the new CEO, mainly the consolidation of its subsidiaries and launch of Bundll, allow for significant upside if successful. While we recommend a wait and see approach right now, this by no means diminishes the bull's case. If the transformation goes according to plan it would certainly be worth a four-star rating.

For a more in-depth look at **AfterPay, Zip Co, FlexiGroup, Sezzle, OpenPay, Splitit** and the Buy Now Pay Later industry take a look at our all-encompassing report https://stocksdownunder.com/buy-now-pay-later-report

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Share price chart

Source: Tradingview

Ever since the 1950s people who know their hydrocarbon geology have been interested in the Perth Basin, a 174,000 sq km area that starts south of the Western Australian capital and ends 1,300 km further north near the town of Carnarvon. A long time ago the Yardarino and Dongara fields became a source of low cost energy for Perth, shipped to that city via the 416 km Parmelia Gas Pipeline which was commissioned in 1972. The next few decades saw many disparate discoveries in the Perth Basin largely concentrated onshore, including about 20 commercial fields.

This is not your grandfather's Perth Basin

Fast forward to 2020 and Warrego Energy is one of many players striving to outdo any previous expectations. The turning point for this company was the 3D seismic program for the EP447 well at West Erregulla, 37 km from the town of Dongara. That work turned in a resource estimate of 1.78 billion cubic metres of gas and 1.2 million barrels of oil in 2018. West Erregulla was the reason Warrego's share price jumped more than sixfold, from around 5 cents at the end of 2018 to over 30 cents by August 2019.

Compare West Erregulla to Australian Worldwide Exploration's discovery of the Waitsia gas field in 2014, a mere 16 km away, and you can start to understand Warrego's newly appointed director David Biggs's belief in West Erregulla's potential as a key prospect in future production. Biggs, former CEO at AWE, will oversee the next phase of Warrego's growth, including the West Erregulla-2 well, and two significant discoveries next door in Wagina and Kingia that were established in 2019. Warrego's share price has fluctuated in the last three months but has recently moved once again above 20 cents, as against a low below 10 cents in March, when Warrego rejected a takeover bid from Strike Energy (ASX:STX).

Few worries as WA tightens its grip on gas

Warrego may have inadvertently strengthened its position as a domestic gas supplier following the WA government ban on the export of onshore gas as LNG (liquefied natural gas). Since Warrego has a 50% stake in West Erregulla (with Strike holding the other half), Warrego claims it is solely focussed on the domestic market in order to meet the widening gap between supply and demand expected over the next ten years.

Outside the Perth Basin, Warrego can look to its Tesorillo and El Romeral gas projects in southern Spain for a way into the European market, which is traditionally reliant on imports. Warrego intends to start with El Romeral and use this field to generate enough cash to then develop Tesorillo. The latter field, a conventional gas play, has a prospective resource of 830 billion cubic feet of gas.

A bright outlook

While Spain is interesting, Warrego, is, first and foremost, a Perth Basin company, and, as such, the outlook is bright. West Erregulla has helped the stock recover from the negative sentiment around oil and gas that followed the oil price crash of earlier this year. The Strike proposal highlighted the potential for Warrego to further reduce infrastructure costs by consolidating with other players in the Perth Basin, which seems likely given all the local (and international) attention.

Given the predicted declines in gas production from the North West Shelf, Warrego feels it is well-positioned to meet future gas demand in the region. Warrego will use its remaining funds to continue its drilling and appraisal program in WA. With so much momentum gained over the last two years, investors will want to watch what Warrego gets up to closely, in the light of a rapidly changing gas market. Four Stars from us.

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.

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