STOCKS
DOWN UNDER

10 SEPTEMBER 2020

Stocks Down Under

You can't have a mid-life crisis in the airline industry because every day is a crisis.

- Herb Kelleher (1931-2019), co-founder and former CEO of Southwest Airlines

MINERAL RESOURCES

Benefiting from iron ore's magnificent run

ALLIANCE AVIATION SERVICES

Soaring above the COVID-19 airline carnage

AMAYSIM AUSTRALIA

The bullet loaded, the chamber spun, now just waiting for the trigger to be pulled

CARINDALE PROPERTY TRUST UPDATE

The market has woken up to the sleeping giant

MINERAL RESOURCES

Benefiting from iron ore's magnificent run

Stocks Down Under rating: ★★★

ASX: MIN
Market cap: A$ 5.2BN
Dividend yield: 3.6%

52-week range: : A$12.11 / A$30.19
Share price: A$ 28.03

Despite a share price drop of 36% during the Corona Crash, Mineral Resources is now making the most of its iron ore mines against a backdrop of high iron ore prices and surging Chinese demand. Aside from being a mid-tier producer, this company has continued to invest in low-cost, next generation mining services as a core part of its growth strategy.

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ALLIANCE AVIATION SERVICES

Soaring above the COVID-19 airline carnage

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ASX: AQZ
Market cap: A$ 546M

52-week range: A$0.97 / A$3.77
Share price: A$ 3.41

Headquartered in Brisbane, Alliance Aviation Services currently operates 40 Fokker aircraft in a fly-in, fly-out air charter operator that services Australia and New Zealand. While COVID-19 has sunk Virgin Australia and caused a price collapse in Qantas, one airline has risen above COVID-19 to achieve not only profitability, but year-over-year profit growth. Capitalising on the success of FY20, Alliance Aviation Services has committed to expanding its fleet.

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Share price: A$ 0.74

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Share price chart

Source: Tradingview

An expansion strategy that has finally paid off

Born in Adelaide in 1993, Mineral Resources provides diversified mining services and owns a growing number of its own mines, mostly in the Pilbara and Goldfields regions of WA. These mines make the company a mid-tier producer of iron ore, graphite and lithium-containing spodumene. Thanks to its growth strategy, the company's portfolio now includes the Mt Marion (40 km south-west of Kalgoorlie) and Wodgina (Kemerton, WA) lithium projects, and its all-important iron ore mines at Koolyanobbing, 54 km from Southern Cross, WA, and Iron Valley and Marillana, respectively 100 km and 84 km from Newman, WA.

Mineral Resources' long-term strategy as a mining services provider has been to invest in new mining projects as well as to lock in the upside from these projects and to secure new mining services work. Mineral Resources' various mining joint ventures have allowed the company to expand its product and service offering in innovative ways, including provision of freight and logistics infrastructure, the supply of portable and modular NextGen-brand crushing plants, and the supply of carbon fibre structural components for mining plant and equipment. We believe the expenditure required to inspire growth is clearly starting to pay off, with mining services alone providing $359m in FY20 EBITDA.

No shortage of potential ventures

Although the focus in the June 2020 quarter has been on iron ore growth, to take advantage of lags in Brazilian steel production and Chinese demand, Mineral Resources has enjoyed high performances from both the iron ore and lithium segments. Results from Koolyanobbing have been the best, with operations at Koolyanobbing lifting to 2.5 million tonnes, from 1.4 million tonnes in the previous corresponding period. In lithium, believe it or not, Mt Marion actually increased its production in spodumene concentrate (the ore containing high-purity lithium) by 17%, but this highlight was offset by lower lithium revenue from adverse pricing and continued oversupply concerns.

While Mineral Resources is not short of potential business ventures or service opportunities, its iron ore growth story has enough traction to keep investors interested while lithium loses confidence. Mineral Resources recently acquired Kumina, another iron ore project in the Pilbara 100 km south of Karratha, paying BCI Minerals (ASX:BCI) $20m cash. Kumina is not only valuable in its own right, but will help optimise Iron Valley in terms of the mining and supply chain services offering.

Iron ore may be where most of the action is right now, but Mineral Resources isn't giving up on lithium just yet. Sure, Wodgina is on care and maintenance, but the joint venture with Albermarle Corporation (NYSE:ALB) is predicated on Wodgina's potential as the largest known hard rock lithium resource, with a mine life of 30 years. Mineral Resources has commenced crushing and logistics services ahead of a restart. With a cash balance over $1.5bn and net cash of $230m as at June 2020, the company can stay in the lithium game for as long as it takes for pricing to return to more like 'normal'.

Let the good times roll? Yes, eventually

The fact that Mineral Resources holds valuable lithium and iron ore mines bodes well for their future endeavours, in our view, and their diversified interests will come in handy should the lithium market hit a new low. The company will likely continue to benefit from the strength of the iron price. And mining services as a business just powers on.

We think, however, that after FY21 Mineral Resources will be ex-growth for a while. Iron ore may be close to US$130 a tonne right now, but the next few years may not be so rich, should Chinese steel production have to slow down a bit and if the Brazilians get their act together.

On consensus numbers Mineral Resources is not expected to grow EBITDA for the next three years or so, apart from a spike in FY21. However, the stock is trading on an EV/EBITDA of about 7x forecast FY23 earnings. Not expensive, but not cheap either given the lack of growth. So, for us, this stock is three stars for a while. Watch carefully, however as a recovery in lithium prices could change the picture dramatically.

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Share price chart

Source: Tradingview

Tell me more, tell me more, like does he have a plane?

Alliance Aviation Services does have a plane, 40 planes in fact. These planes make up the backbone of the company's revenue stream, which is split into five distinct categories: Contract Revenue, Wet Lease, RPT Revenue, Charter Services and Aviation Services.

Contract Revenue is the primary segment of Alliance Aviation Services consisting of 67.9% and 59.4% of total revenue during FY20 and FY19 respectively. Contract Revenue consists of long-term contract air charter services of workers and contractors who work for major mining and energy companies. These agreements are made with the mining and energy companies in question. At the same time, revenue is earned for each 'per round trip' basis while any costs from foreign currency movements, fuel prices and costs associated with changes in the consumer price index are automatically passed through to the companies.

This means that Alliance Aviation Services does not have to pay these costs. However, this can cause fluctuations in revenue that are not due to material changes, but rather to these pass-through charges. Investors can perform a quick sense check by looking at the year-over-year growth in operating expenses compared to the year-over-year increase in Contract Revenue as well as the footnote explanations. Due to the demands of social distancing, Alliance Aviation Services saw a year-over-year increase during FY20 in both revenue generated and flight hours of approximately 22.5% and 20.7% respectively.

Alliance Aviation is more than just Contract Revenue

Wet Lease was suspended in March 2020 due to COVID-19 and is expected to resume slowly throughout FY21. However, we believe it is important to mention that management stated in its FY20 results presentation that it had not assumed any income from Wet Lease in its FY21 projections. In the aviation business, a Wet Lease is an arrangement made with another airline to provide an aircraft, crew, maintenance and insurance in-exchange for payment based on the total completed block flight hours. This led to an understandable 46.3% year-over-year decline in revenue from FY19. However, this revenue segment only accounted for approximately 16.4% of FY19's total revenue.

RPT Revenue services several regional airports in Australia with scheduled and ticketed flights. The RPT Revenue segment took the second-largest hit with revenue declining approximately 16% from FY19. However, using FY19 numbers, RPT Revenue contributed around 14.9% of total revenue for FY19. It is likely that FY21 will see a slight improvement from FY20, but this revenue segment is unlikely to reach its FY19 levels. We believe Qantas (ASX:QAN) would offer a slight bellwether for the recovery of this revenue segment.

Charter Services was the only revenue segment, besides Contract Revenue, that saw an increase during FY20 as individuals opted for solo or restricted attendance flights over more traditional airline offerings. Revenue increased by 98.5% compared to FY19 and the company believes this segment will continue to outperform during FY21. However, we believe this segment's growth could be held back by clients switching to long-term contracts, in itself a positive development.

Aviation Services operates by leasing and selling its aircraft and aircraft parts and by providing line and heavy maintenance services to other aircraft operators. During FY20 this segment posted an 8.1% revenue decline. We expect this revenue segment will continue to be the smallest for the company, excluding any COVID-19 related hits in the other revenue segments.

COVID-19 can't stop the expansion

On 8 August 2020, the company announced the purchase of 14 Embraer E190 aircraft. While the purchase also included inventory, parts, tools, training equipment and devices as well as an option to buy an additional five E190s at a later date, the majority of this US$79.4m purchase was the 14 aircraft, which are expected to be delivered over eight months from September 2020. The company confirmed that this purchase will be funded by the proceeds from the 11 June share issue.

While Alliance Aviation Services may have cancelled its 2HY20 dividend to preserve cash, we don't believe that will continue for much longer. Net cash inflow from operating activities was $44m during FY20, an increase of around 18.9% year-over-year. Additionally, from a balance sheet perspective, cash and cash equivalents are sitting at $98.8m. At the same time, total borrowings and lease liabilities totalled $62.8m, or a ratio of 1.6x cash to total borrowings and lease liabilities as of 30 June 2020. We are highly confident in the company's financial health for the foreseeable future.

The strike of the market can hit all

Alliance Aviation Services mainly operates in a niche compared to most of the airline players listed on the ASX. However, investors have been treating it like it operates under the same business plan as the other, more traditional, airlines.

Between FY21 and FY23 the Compounding Annual EBITDA Growth Rate is estimated to be approximately 12.7%. However, the company is trading at a consensus estimated FY21 EV/EBITDA ratio of approximately 6.2x, a valuation we find to be significantly undervaluing the next three years growth and the strength of Alliance Aviation Services' 1.6x cash to total borrowings and lease liabilities ratio. Therefore, we are issuing a four star rating.

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Share price chart

Source: Tradingview

All that remains

On 31 August 2020 AGL Energy Limited (ASX:AGL) signed a binding contract for the entire subsidiary of Amaysim Australia's electric and gas utility for $115m. The concern around this sale is what Amaysim Australia is going to do now. Taking a look at FY20's results shows the utility subsidiary accounted for approximately 61% of total revenue generation. While this division was going to have a significant amount of hardship down the line due to bad debts from COVID-19 and a sharp increase in regulation, compared to the consolidated company, the remaining mobile service provider division is not nearly as large. Therefore, the majority of Amaysim Australia's current market capitalisation is currently based on a large pile of cash, especially since Amaysim Australia has seen a rally of approximately 5% since the announced sale.

So, what is left? We know that reading a bunch of numbers can be boring, but we think it's important to list out the earnings statistics for the remaining mobile service provider activities of Amaysim Australia. During FY20, net revenue saw a decline of about 6.1% year-over-year to $190.1m, gross profit increased around 13.1% to $77.8m and underlying EBITDA declined approximately 36.2% to $11.4m. However, the decline in EBITDA was solely due to a $7.3m increase in advertising expenses. If we take out the increase in marketing, EBITDA would have seen a rise of approximately 11.8%. We highlight this to emphasise that Amaysim Australia's mobile operation is choosing to sacrifice EBITDA growth now in exchange for increased exposure.

Let's get our Scrooge McDuck on

The sale of Amaysim Australia's utility division has left the company with a significant amount of cash and no obvious uses for it. As we mentioned above, this is not a situation where Amaysim Australia can simply slowly utilise the cash for balance sheet improvement or slow and steady capital expenditure funding. We believe there are four likely scenarios for what Amaysim Australia will do with the cash.

A one-off special dividend. This seems like the least likely option as we believe it would end up causing a significant rout in the share price since it would remove any real opportunity to replace the significant hole in Amaysim Australia's revenue production. If this option is taken up by management, we believe no other rating would be acceptable besides two-stars, with the recommendation that current investors stay just long enough for the ex-dividend date. While there is the possibility that any of the following options will include a special dividend, due to the lack of an adjustment in the market capitalisation of Amaysim Australia following the sale, we would look poorly on any use of the proceeds from the sale in a special dividend distribution, especially in the age of COVID-19.

A significant uptick in capital expenditure and operational expenditure over the next couple years with the goal to see large increases in market share. Unfortunately, this is an option we are unsure how-to analyse at this point due to Amaysim Australia's status as a Mobile Virtual Network Operator. MVNO's piggyback on other companies' network infrastructure allowing Amaysim Australia to not own any networks of its own. However, due to the lack of clear guidance on the plans for the cash and no clear avenues for significant increases in spending that will create a clear and substantial increase in revenue to make up for the sale of 61% of Amaysim Australia's annual revenue, we do not believe this alone will prevent a drastic decline in shareholder value.

A single, or series of, significant acquisitions to vertically expand the mobile division or grow the division in a non-organic way. If we assume a singular path of action by management, we believe this would be the most beneficial for long-term shareholder value stability. However, we have not seen any indication from management of major acquisition targets, nor have we heard of any market rumours.

The fourth, and we believe most advantageous for future shareholder value, is a combination of drastic capital and operational expenditures and acquisitions. However, we remain sceptical of even this option's ability to replace 61% of annual revenue production and around the same percentage of EBITDA generation.

So Amaysim Australia is overvalued then, right?

From an intrinsic perspective, it really is impossible for us to answer this question without reviewing the yet unreleased plans from management. However, we remain highly sceptical of management's ability to replace this gap in annual revenue and EBITDA generation. To be clear, the sale was definitely the right move for Amaysim Australia due to the heightened risk from COVID-19 and increased regulation posed to the utility division. Additionally, the mobile network division is healthy with a strong, and consistent, historical track record of EBITDA and active customer growth.

Our issue with the stock relates to Amaysim Australia's shares rising around 5% since the sale was announced despite a lack of answers surrounding the large, double red underlined question: now what? The problem is that we feel like spectators waiting on a game of Russian Roulette where the bullet has been loaded, the chamber spun and we are all just waiting on management to pull the trigger. Therefore, until we have additional clarity, we believe the only proper rating would be a skittish three stars.

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Share price chart

Source: Tradingview

On 25 August 2020 we published our analysis and four-star rating for Carindale Property Trust after COVID-19 caused a 49.2% decline in the share price to $2.85, which implied a discount of 54.7% to net tangible assets. We argued that rental income had begun to normalise and that the new, small cluster in Brisbane was not enough to derail the recovery of Carindale Property Trust's property, Westfield Carindale. Additionally, we stated that a resumption of dividend payments was likely to occur at the latest during 2HY21.

On 8 September 2020, Carindale Property Trust released a statement to the market that August 2020's total rental collections represented 98% of gross rental billings, indicating the normalisation of Westfield Carindale. The news caused Carindale Property Trust to open over 20% higher and end the day up approximately 16% at $3.03 a share. We believe this is a sharp indication of the market's realisation that Carindale Property Trust has been significantly underestimated by investors. Further shown by the 0.7% increase Carindale Property Trust's shares yesterday, 9 September 2020, despite the rally the day before and the overall market decline of approximately 2.15%. Therefore, we are reiterating our four-star rating at this time.

To review our more in-depth analysis of Carindale Property Trust published on 25 August 2020, please view our previous publication here: https://stocksdownunder.com/edition/cleanaway-waste-management-alkane-resources-carindale-property-trust/

Pitt Street Research Pty Ltd

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