STOCKS DOWN UNDER

11 SEPTEMBER 2020

# Stocks Down Under

*“Cricket is basically baseball on valium.”*

**- Robin Williams (1951-2014), American actor and comedian**

## NEXTDC

Growth at too high a cost

## ATOMO DIAGNOSTICS

Rapid diagnostic pioneer

## RED 5

Crown it King of the Hill

## AMP LIMITED UPDATE

S&P confirms its all over

# NEXTDC

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Stocks Down Under rating: ★★

**ASX: NXT**
**Market cap: A$ 4.9BN**

**52-week range: : A$5.91 / A$12.48**
**Share price: A$ 11.16**

NextDC is Australia's leading data centre operator with nine data centres between Brisbane, Canberra, Sydney, Melbourne and Perth. One of the more unique aspects of NextDC's data centres is its partnership with Qantas Future Planet, which allows its data centres to achieve 100% net carbon neutrally, through a combination of solar panels. When combined with consistent, high-level EBITDA growth, we believe NextDC is really in a league of its own. However, the company's stock price is a classic example of a great company getting ahead of itself, in our view.

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# RED 5

## Crown it King of the Hill

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**Market cap: A$ 666m**

**52-week range: A$0.18 / A$0.37**
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Red 5's rollercoaster performance on the ASX over the past few years shows how on-the-ball you have to be when investing in resource stocks. The junior gold producer saw its investors run quickly away after its loss of almost $100m on the Siana Gold Mine in the Philippines. Since then, Red 5 has successfully expanded its territory in WA and revived its Darlot Mine and while 2020 has dredged up new challenges these are being overcome. And King of the Hill is coming.

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### Share price chart


*Source: Tradingview*

### Datacentres are the centre of the modern universe

NextDC operating revenue comes from its data centres, which are based in major cities across Australia. Datacentres have become a prominent feature of the modern, internet-based era, and as Australia shifts more into technological exports, NextDC has positioned itself to take advantage.

As of FY20, 89% of NextDC's installed capacity was contracted out. While this is a decline from FY19s 90%, NextDC added 20 MegaWatts of additional capacity, an increase of over 30%. This highlights one of the main attractions of NextDC, its recurring revenue. The vast majority of NextDC's utilised capacity is contracted out in a recurring setting. Data centres are an essential part of modern business operation and demand is not a concern that is present in our short or long-term analysis.

Over the next couple of years, NextDC plans to increase its MegaWatt capacity by approximately 312% by building new datacentres and expanding the ones it is currently operating. This does lead to one of the largest risks, not for NextDC, but for investors. We will elaborate on in this below, but it is important to briefly mention that this expansion has, and will be, funded by large instances of share dilution.

### I'm an investor; why should I care about carbon offsets?

Through three main methods, NextDC has enabled its operation to be 100% net carbon neutral. The primary method is its partnership with Qantas Future Planet in the purchase of carbon offset credits. Additionally, NextDC has also been investing heavily in increasing the efficiency of its datacentres and installing large solar generation capacity. Excluding the strong possibility that there will be a mandatory carbon tax/credit system in the next five to ten years, this opens NextDC up to large amounts of liquidity not available to other datacentre operations. Datacentres are notorious electricity consumers and therefore, have been at the forefront of recent climate change debates. With the significant rise around the world in Environment, Social and Governance based investing, especially with Superannuation, NextDC is a rare example of a datacentre player that meets the requirements of these investors and funds. Since NextDC will require significantly more capital to accomplish its expansion plans, we believe this access to additional liquidity will help reduce the consequences of the dilution to current investors.

### The brass tacks of it all

Due to significant depreciation and amortisation expenses, NextDC does not offer a positive Net Profit After Tax result. Therefore, we believe revenue and EBITDA metrics are far more accurate depictions of the company's performance. EBITDA growth during FY20 presented another solid year at around 23% growth year-over-year, but more importantly, NextDC has continued to grow its annualised revenue per square metre. This metric is important because it shows how NextDC can continually squeeze more profit out of its already constructed space in addition to the construction of new capacity. For FY20 annualised revenue per square metre grew approximately 2.2%. We expect this trend to continue through FY21.

### Sounds good, but let's see the cold hard cash

Due to equity issued during FY20, NextDC's cash and cash equivalents are more than enough to cover the total of its borrowings. We do not believe the level of debt or interest payments are a concern for investors in NextDC. Total assets are over 2x total liabilities with approximately 36% of NextDC's total assets being comprised of current assets. Unsurprisingly, however, the vast majority of NextDC's assets are in the property, plant and equipment that make up its datacentres.

The company has consistently strong net cash flow from operations. During FY20, excluding costs to acquire subsidiaries during FY19, NextDC grew its net cash from operations around 11.6% year-over-year to $53.9m. However, net cash used in investing activities continues to be around 7.5x greater than net cash generated from operating activities due to the vast expansion and construction NextDC is currently undergoing. We expect this to continue for at least the next couple of years and this is why NextDC has and, will continue to issue large amounts of new shares in the coming years.

### Great company but overpriced to the extreme

NextDC is a fantastic company with a very profitable future. However, the current valuation looks too far out and in our opinion, does not adequately reflect the equity dilution the company will require shareholders to take on. NextDC is one of the more highly analysed companies on the ASX and the consensus estimates for the Compounding Annual Growth Rate of EBITDA over the next three, four and five-years are approximately 28%, 31% and 30%, respectively.

Meanwhile, NextDC is currently trading at an EV/EBITDA ratio of 39.3x for FY21 although its EBITDA is only expected to grow by 23% this year. Looking out longer term, i.e. FY25, the stock is trading at an EV/EBITDA of 13x. While a 5-year CAGR of 30% compared to an estimated EV/EBITDA ratio of 13x might look amazing, we would remind investors that this is based on FY25's expected EBITDA and NextDC shareholders will have to deal with significant dilution between now and then. Therefore, we have no choice but to issue a two-star rating.

# RED 5

## Crown it King of the Hill

**Stocks Down Under rating:** ★★★★

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Red 5's rollercoaster performance on the ASX over the past few years shows how on-the-ball you have to be when investing in resource stocks. The junior gold producer saw its investors run quickly away after its loss of almost $100m on the Siana Gold Mine in the Philippines. Since then, Red 5 has successfully expanded its territory in WA and revived its Darlot Mine and while 2020 has dredged up new challenges these are being overcome. And King of the Hill is coming.

### Share price chart


*Source: Tradingview*

### Home, sweet home, but with challenges

Nestled away in the Eastern Goldfields of WA are Red 5's two main gold plays in Australia and its shot at redemption in terms of shareholder value creation:  the Darlot Gold Mine and King of the Hill (KOTH), both about 900 km from Perth. Darlot, which can be found 30 km from Leonora township, has been in operation since 1988 and has continued to yield favourable results, averaging about 80,000 ounces a year. The King of the Hill underground mine (acquired in 2017) is only 80 km from Darlot. Of less relevance right now, but potentially valuable down the track, is Red 5's stake in the Siana Gold Mine and the nearby Mapawa Gold Project, located in the Filipino province of Surigao del Norte, at the northern tip of Mindanao Island.

While Red 5 has really concentrated its efforts on picking itself up and establishing its status at home after an unhappy experience at Siana, some investors remain unconvinced. After kicking off 2020 with plans to complete final feasibility studies and expand underground operations at KOTH, the small-cap producer has suffered a series of setbacks, starting with a revised forecast in gold production at Darlot as a result of crusher breakdowns and higher dilutions of ore than expected, bringing production back to 21,000 ounces from a guidance of 26,000-30,000 ounces in June.

While equipment problems have now been remedied, Darlot's initial guidance of 98,000-120,000 ounces for FY20 ended up being 93,000. To make it worse, the company's sudden announcement that it would 'scale down' production at KOTH to address Darlot's dilution woes and begin open-pit mining at the newly purchased Great Western project by December 2020 did not thrill its shareholders, with the shares falling from 30 cents to 22 cents.

## Red 5 has options at Darlot

While the lower-than-forecast average grades were a blow, the fall appears slightly premature: Red 5's decision to refocus its efforts on the Great Western gold deposit (an 80 km trucking distance from Darlot) is part of its transitional strategy to expand and improve the operations of the ageing Darlot Hub. In reality, Great Western is just one of many expansion opportunities available to Red 5 in the immediate area.

As for KOTH, the $125m share placement conducted back in April will help establish the long-term potential of the project, including its own processing hub. KOTH remains one of WA's premier up-and-coming gold projects, with the latest round of drilling programs suggesting a mineral resource estimate of 401,000 ounces in 2.71 millions of tonnes of ore (4.6 g/t). As KOTH won't be in a position to deliver strongly for a while, Red 5 is more concerned about stabilising production at Darlot in the near term to meet its FY21 forecast.

## Unclear path for miners under Duterte

Meanwhile, Red 5 hasn't forgotten about its interest in the Siana Gold Mine, which avoided suspension by the Filipino government in 2016 only to be suspended in April 2017 pending improved changes to operating conditions. Red 5's shutdown costs have approached a cool A$100m. The Philippines' crackdown on gold producers, which it feels do not comply with environmental regulations, has been a major problem for Red 5 and others, including Oceana Gold (ASX:OGC) and BHP Billiton (ASX:BHP).

President Duterte and his cabinet have enacted a hard-line stance against mining generally and they haven't left much room for existing miners to manoeuvre.  After the fallout from the first attempt to keep the government happy, Red 5 still has a stake in Siana through its Philippines affiliate company Greenstone Resources Corporation, but is unable to provide any outline for the future of this mine. That said, there is hope in the local mining community that the government will recognise the industry's importance to sustaining the Filipino economy through the Pandemic.

## KOTH final feasibility study coming soon

So, if things have been so disastrous for Red 5, how come we like the stock? And how come it has re-rated so nicely since late June? We think it's KOTH that can pull the irons our of the fire.

Assuming the end-of-September final Feasibility Study for the KOTH project doesn't provide any further setbacks, Red 5 still has the capacity to evolve into a competent mid-tier gold producer. The Prefeasibility Study capital cost estimate for KOTH was $218m. If that doesn't change too much in the upcoming study, Red 5 is well placed to get the project financing it needs, helped by its own $122m cash balance.

KOTH and better gold prices are the two main reasons why consensus EBITDA for this company can get to over $70m in FY22 and close to $150m in FY23. On the latter number Red 5 is currently on an EV/EBITDA multiple of approximately 4.5x. Looks good to us. Four stars.

# ATOMO DIAGNOSTICS

Rapid diagnostic pioneer

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### Share price chart


*Source: Tradingview*

When we first heard about Atomo Diagnostics we kind-of shrugged. Rapid diagnostics? So what? The thing about diagnostic testing is that it has been rapid for a long time. That pregnancy test you can pick up from your local supermarket is a case in point. It can tell a woman whether or not she's pregnant in about three minutes. The test format is called a 'lateral flow immunoassay', and the technology to make it, and deliver it at very low cost, has been around since the 1960s and in everyday usage since the 1980s.

### Simple science still allows for innovation

The lateral flow part of a lateral flow immunoassay refers to the fact that in this kind of diagnostic the fluids from the sample being tested, as well as the various chemicals involved in the test, are made to flow along a membranous strip made out of a chemical, such as nitrocellulose. In a line across that strip, called the 'test line', are placed the antigens representing the substance for which an assay is required, while slightly further up the test kit is positioned a line of human antibodies called the 'control line'. Once the fluid has completed its trip up the nitrocellulose strip there will be either one or two red lines. A red line at both the test line and the control line mean that the test was positive. A red line at the control line means that the test was negative. The science behind lateral flow is so simple any high school biology student who pays attention in class can understand it.

Atomo Diagnostics has positioned itself as the Next Big Thing in lateral flow immunoassays. It rightly argues that a lot of the lateral flow tests that are marketed today aren't as user friendly as the pregnancy test we cited above. They tend to be shipped in boxes with multiple components that are easy for the user and clinicians to mishandle. Atomo's tests, by contrast, are fully integrated and very user-friendly. The folks at the Bill & Melinda Gates Foundation liked Atomo's technology so much that in October 2016 they provided a US$2.6m grant to create an HIV self-test. The result was AtomoRapid HIV-1/2, which can return a result in 15 minutes, proving that even simple and old-fashioned science still allows for company-making innovation. Before Atomo no one had created a reliable blood-based rapid diagnostic for HIV that was fully-integrated and therefore suitable for self-testing, even though HIV had been with us as a serious pandemic since 1981 and between 1 and 2 million people a year still acquire HIV every year around the world.

### A large multiple of sales

So, fair enough, Atomo Diagnostics has earned its stripes as a rapid diagnostics pioneer. However it was the Scots-American steel magnate Andrew Carnegie (1835-1919) who reportedly said 'pioneering don't pay'. In FY20 Atomo only made $5.4m in revenue and lost $2.4m in underlying EBITDA. Yet it was able to IPO at $112m post-money, and then double from there. We think that wasn't because of HIV, where the need for testing is greatest in emerging jurisdictions that can't afford to pay much. It was because of COVID-19.

Again, hats off to Atomo – at a time when a lot of not-so-good diagnostic tests made their appearance, this well-run company came out with a reliable antibody test right when it was needed to take the strain off expensive and relatively slow PCR-based testing. However the thing about COVID-19 is that it won't always be with us. At that point, when the urgency has gone out of the Life Sciences ecosystem as far as investors are concerned, we fear that a lot of companies whose share prices went up because of the virus will trend back down again.

### Playing a long game

Atomo Diagnostics is, to its credit, playing a long game. It has a pipeline of new test platforms that it will commercialise over time, and intends to develop point-of-care tests for a wide range of conditions. Point-¬of-care is where a lot of the action will be in diagnostics in the future, so Atomo is on the right side of history. And as the utility and reliability of its original tests become more widely known, the opportunity to partner for future products will grow.

Add in the fact that founder and CEO John Kelly, whose previous ports of call have been ResMed and the retractable syringe pioneer Unilife, knows a thing or two about business development, and we predict a good future for this company.

In the meantime, however, Atomo feels a little expensive to us. Right now, you can get Universal Biosensors (ASX:UBI), another maker of point-of-care diagnostic, for only about A$55m. Another reason why we currently rate Atomo at only three stars. The stock has been generally trending up since June but that trend could be temporary.

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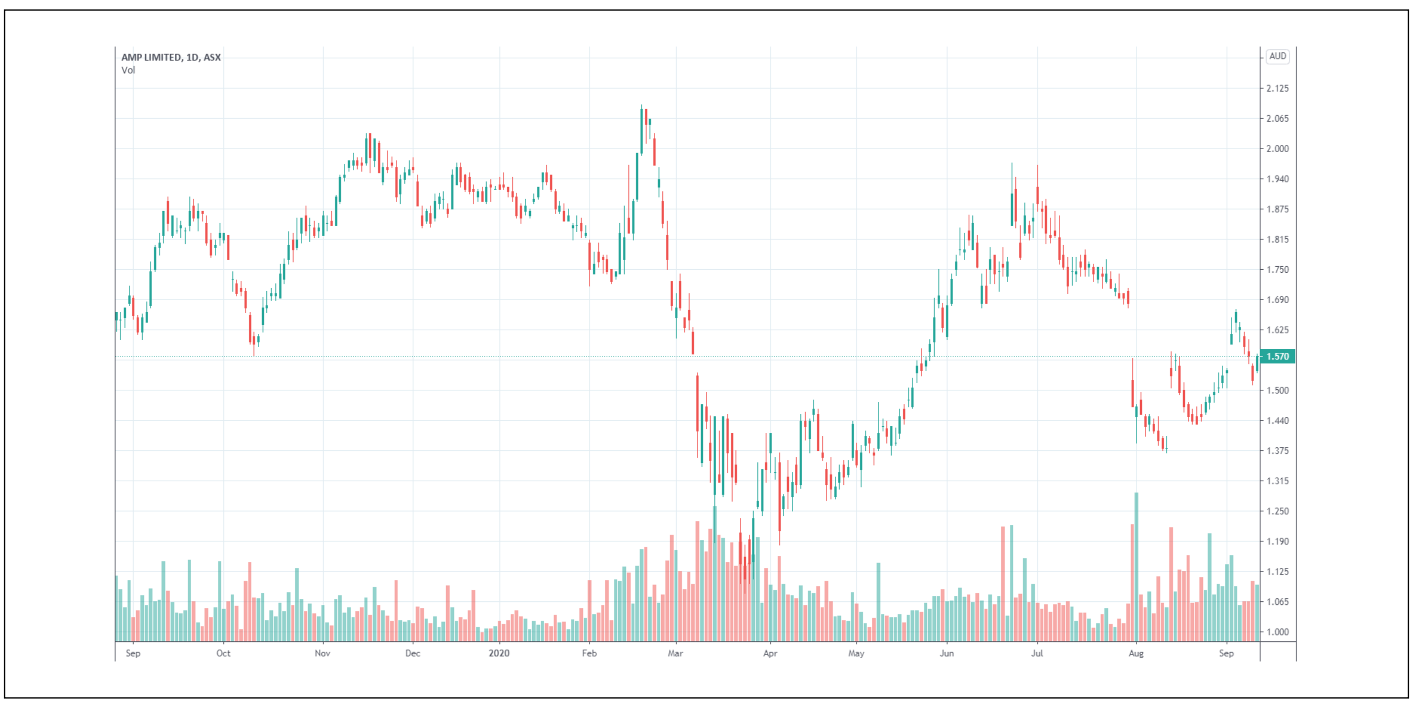


*Source: Tradingview*

This new information just strengthens our analysis laid out in our 4 September 2020 publication. AMP Limited needs to be broken-up rather than continuing to attempt a revitalisation. The parts have significant value, but the company's management have utterly trashed and tarnished the AMP brand beyond repair.

Therefore, we are restating our four-star rating with the assumption that the company will be sold for parts. If the company's portfolio review does not result in a sale of the company, then we believe it deserves a toxic two-star rating. However, recent developments and continued investor pressure make this situation all the less likely in our view.

To review our more in-depth analysis of AMP Limited published on 4 September 2020 please view our previous publication here:

https://stocksdownunder.com/edition/amp-limited-gdi-property-group-next-science/

**Pitt Street Research Pty Ltd**

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