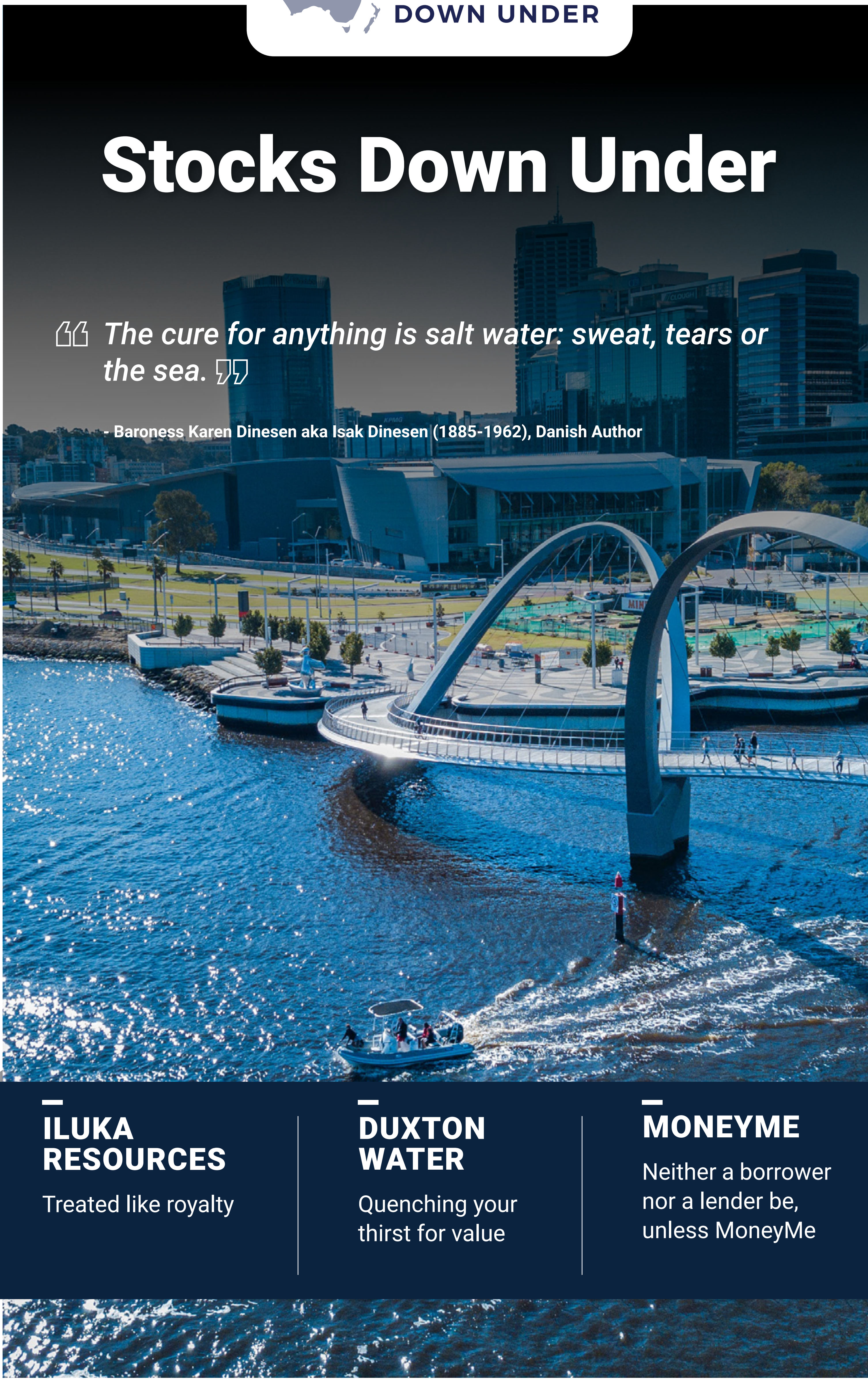
STOCKS DOWN UNDER

17 SEPTEMBER 2020



Stocks Down Under

> *"The cure for anything is salt water: sweat, tears or the sea."*
>
> - Baroness Karen Dinesen aka Isak Dinesen (1885-1962), Danish Author

ILUKA RESOURCES

Treated like royalty

DUXTON WATER

Quenching your thirst for value

MONEYME

Neither a borrower nor a lender be, unless MoneyMe

ILUKA RESOURCES

Treated like royalty

Stocks Down Under rating: ★★★★

ASX: ILU
Market cap: A$ 4.1BN

52-week range: A$5.72 / A$10.58
Share price: A$ 9.62

Iluka is focused on moving its global network of mineral sand operations forward during this Pandemic. The stock is moving forward as well. From a low of $4.30 in March, Iluka's shares were back to $7 by August and are now close to $10. While demand for its mineral resources remains flat, it will come back in the medium term, but in the meantime, there is strong interest in the company's planned demerger of its iron ore royalty business.

READ MORE

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Stocks Down Under rating: ★★★★

ASX: D2O
Market cap: A$ 156M
Dividend yield: 4.4%

52-week range: A$1.01 / A$1.60
Share price: A$ 1.31

Duxton Water is the only ASX-listed investment vehicle that provides direct exposure to water. We believe this means that the company, and the water investment industry as a whole, is highly misunderstood in Australia and therefore, chronically undervalued. There are very few things humanity and society would collapse without, and water is number one on that list. The United Nations estimates that by 2030 the world will be in a 40% global water deficit, and Australia is no exception. Therefore, the entitlements owned by Duxton Water are chronically undervalued by both the equity and water markets, in our view.

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Share price chart

Source: Tradingview

Iluka is a big wheel globally in the world of mineral sands, that is, zircon and the titanium minerals. Its Jacinth-Ambrosia Mine, to date the world's largest zircon mine, sits 90 km north of Yalata, a tiny coastal town on the Great Australian Bight in the western part of South Australia. The heavy mineral concentrate produced at Jacinth-Ambrosia is transported to Iluka's processing hub at Narngulu, WA, to be processed into the final zircon, rutile and ilmenite products. Both rutile and ilmenite are minerals naturally abundant in titanium dioxide, something industry needs a lot of these days.

Demand falters but Iluka firm on expansion

Iluka's production and sales of zircon, rutile and synthetic rutile have all taken a hit with the current crisis. Total output of the three commodities in the June 2020 quarter was 135,000 tonnes, versus 169,000 tonnes in the June 2019 quarter. Basically, Chinese buying temporarily dried up early in the crisis and Iluka tweaked its production accordingly. Or, in the case of the Sierra Rutile mine in Sierra Leone, it was forced to tweak production thanks to COVID-19 border closures and fewer specialised workers being available.

All of which sounds bad, but Iluka is actually in a good position when it comes to rutile because of take-or-pay contracts – contracts obligating payment or delivery – which has helped to deliver 70% of previous production guidance. As for Sierra Rutile, we believe it still has a bright future. This operation encompasses the largest rutile deposit in the world and comes with an established operating history and something like 20 years in reserve.

Eneabba project ahead of schedule

Iluka is pushing forward with expansions elsewhere and shows little concern in its ability to manage supply in the medium and longer term. A new mine at Cataby, 150 km north of Perth, was commissioned during the second quarter of 2019 chiefly for ilmenite. It will add to the company's processing potential at Capel, which focuses on producing synthetic rutile, an upgraded form of ilmenite. Iluka has also begun production ahead of schedule at Eneabba, 150 km from Geraldton, WA, in what is the company's first rare earths project. April's Phase One initiative has already resulted in the extraction and processing of both zircon and rare earth elements, including monazite, at Eneabba.

Deterra Royalties the next big pure play

In 2019, Iluka commenced a review of its capital and business structures, including its royalty rights in Mining Area C (MAC), a major iron ore deposit in the Pilbara operated by BHP Billiton (ASX:BHP).

The decision to demerge the royalty business from mineral sands mining is a no-brainer, according to Iluka. That's because the newly-formed Deterra Royalties will be focussed on the high earning potential of iron ore and the impressive sales volumes from BHP's operations, something that at the moment is overshadowed by Iluka's other operations. As Iluka will retain a 20% interest in Deterra for the long term, it will still enjoy some MAC income that it can earmark for further exploration and growth of Iluka's primary focus on rare earths. Since production began in 2003, MAC has contributed $929m in total revenue for Iluka, with a contribution of $48m in the half-year to June 2020. This money-tree is set to grow taller for Deterra, as BHP is expecting a boost in production from 55 million dry metric tonnes to 139 million from 2023 after a further expansion of Mining Area C's South Flank.

Assuming the demerger is approved, Deterra will be Australia's largest resources royalty company. Already an established model in North America (think Franco-Nevada), royalty cash flows offer an alternative source of financing for mining projects and deliver greater returns to investors through exposure to typical miners, often without the same capital or operating costs. Deterra Royalties is set to provide 1.23% iron ore royalty per annum over MAC's predicted mine life of 30-plus years.

Diversify and conquer

Given the upheaval of 2020, Iluka has been proactive in making disciplined production changes to meet market conditions and preserve cash, of which it held $62m as at June 2020. As Iluka and its sister Deterra provide a clearer picture for shareholders, we have little concern for Iluka's future, although we are keeping an eye out for potential oversupply in zircon.

As the only non-precious metal royalty company, there is room for Deterra to grow from a single-royalty stream to a portfolio of resource streams, including rare earth elements. If not, we believe the cashflow from Deterra will benefit Iluka's exploration zeal in the long run.

Currently Iluka is trading an EV/EBITDA multiple of 9.6x FY21, starting in January. With earning set for a strong rebound in that year, as mineral sand prices recover, that looks reasonable to us. Four stars.

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Share price chart

Source: Tradingview

Water, what is it good for? Absolutely everything.

Literally every industry uses water in some way, shape or form directly or indirectly. For instance, a large fabrication facility in the semiconductor industry uses more than 18m litres of water per day. Between 2016 and 2018, over 15,000 hectares of almond trees have been planted in the Murray Darling Basin, with the vast majority yet to reach maturity. Almond tree saplings use 2-3 megalitres of water (1m litres) per hectare per year. Almond trees take around 5-years to start producing and a large portion of the almond production on the Murray Darling Basin has not yet reached maturity. Once these trees mature, they require around 14-16 Megalitres of water per hectare, per year. The vast majority of farms choose to purchase water off the market and very few purchase the entitlement rights.

Just accounting for the almond trees alone, we believe water entitlements are systemically under-priced. To give a small comparison, perpetual entitlement contracts in California cost around $15,000 to $20,000, while in the Murray Darling Basin they cost around $8,000 as of 30 June 2020. California's water is also widely believed to be systemically undervalued by experts.

Digging into the portfolio

Duxton Water owns perpetual water entitlements in five regions, Murray (SA) 68% of Net Asset Value, Goulburn (Vic) 14% of Net Asset Value, Murrumbidgee (NSW) 13% of Net Asset Value, Lachlan (NSW) 4% of Net Asset Value and Mallee (Vic) 1% of Net Asset Value. All five of these regions are part of the vital Murray Darling Basin. The basin provides a significant portion of New South Wales, Victoria and South Australia's water.

Excluding unrealised capital gains, Duxton Water's Net Asset Value per share equals $1.79. To put it simply, if Duxton Water was to sell all of its assets today, investors would receive a payout of $1.79 a share excluding capital gains tax as of 31 August 2020.

The company's business model is rather simple, take the cash flows from selling the water provided to Duxton Water through its perpetual entitlements and distribute part of it as dividends. Meanwhile, take the rest and use it to purchase more perpetual water entitlements. During 1HY20, Duxton Water purchased an additional net 695 Megalitres of perpetual water entitlements. This is an increase of approximately 1% of its total perpetual water entitlements of 83,045 Megalitres on 31 December 2019.

Earnings as clear as the water Duxton sells

Duxton Water earns revenue in two separate ways, long-term contracts and active management. The majority of Duxton Water's perpetual water entitlements operate under long-term leases with irrigators. While the current portion of the value of its portfolio under these long-term leases is 63% as of 31 August 2020, the long-term goal of Duxton Water is to increase this portion to 70-80%. Active management is fairly straightforward; the unleased portion of Duxton Water's portfolio, currently at 37%, is sold on the market. While this can often yield a price higher than that paid by Duxton Water's long-term contracts, there is no guarantee of this. Therefore, for the sake of earnings consistency and planning, Duxton Water is attempting to significantly raise its long-term leased portion to 70-80% while leaving 30-20% open to the potential upside of the market.

A hidden value play with a solid dividend, what more do you want?

Duxton Water consistently trades under its Net Asset Value of $1.79 per share. This is for a couple reasons, including lack of investor awareness or understanding of the situation with water. However, we believe one of the significant reasons for the undervaluation is the consistent bad press the industry is given. The press is constantly rife with stories and speculation around government crackdowns on the industry, or even forced sales. These fears are beyond unfounded, in our view.

First of all, as of the close on 17 September 2020, Duxton Water was trading at $1.31 or a discount of around 27%. Second of all, increased regulation is actually something Duxton Water is fighting for. According to accounting standards in Australia, water entitlements are actually considered an intangible asset.

Over $2bn worth of water entitlements were traded during 2019 in Australia and therefore, we believe this is a strange accounting concept. Increased transparency, regulation and oversight in the industry will help it mature and encourage more investment, in our view. This will only benefit Duxton Water and the federal government has actually been purchasing 30% of the outstanding perpetual water rights in the Murray Darling Basin over the last 20-years, and it has always been through willing sellers. This water is then kept in the basin instead of sold or used.

Lastly, the price of water, unlike all other commodities, is severely undervalued globally. While we don't have enough space here to go over the why, there is a significant amount of academic literature dedicated to this concept.

Duxton Water has a long road ahead to get investors to understand its value, but the truth is, it's a ridiculously misunderstood and undervalued company, in our view. Combined with its growing 4.4% dividend yield, we believe there is no other rating for it besides four out of five stars.

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Share price chart

Source: Tradingview

If the world had a fuel, it would be credit

MoneyMe's main business remains personal loans, despite declining from 78% of its total loan book during FY19 to 59% during FY20. The main aspect of MoneyMe that sets its personal loan business apart is the fact that around 80% of its loan applications are fully automated. This has been achieved through a combination of extensive databases and artificial intelligence innovation. The average loan is approved in approximately five-minutes. While these loans range from $2,500 to $50,000, the average for FY20 was $5,200 at around 8.99% interest per annum. While we don't know the average loan term for the personal loan portfolio specifically, the total portfolio had an average term of 24-months during FY20. Since 59% of the loan portfolio is personal loans, we assume the average personal loan term is also approximately 24-months.

Freestyle represents approximately 39% of MoneyMe's loan book and offers a virtual MasterCard with tap 'n' pay and online payment options. The card is targeted at lower credit customers as it offers a hard cap of $10,000, although not everybody can qualify for $10,000 of course. FY20 was a fantastic year for Freestyle; its total loan book expanded around 170% year-over-year and has a strong growth trajectory during FY21.

ListReady was launched in August of 2019 and so we don't have a complete 12-month period of results for FY20. ListReady has already seen success, though, as it has signed up around 350 agencies, 2,000 agents and funded 1,300 customers. With the real estate market beginning to awaken again, and lockdowns unlikely to re-emerge in Australia, we believe launching this business is likely to prove to be a smart move during FY21.

Both RentReady and MoneyMe+ were released after 30 June 2020, and therefore, we don't have any information on the financial performance of these products. It's important for investors to keep an eye out for MoneyMe's annual general meeting for further information.

Personal loan vendor = bad average credit, right?

While there is definitely a perception out there that the use of a personal loan company, excluding Buy-Now-Pay-Later, means the individual has poor credit, we believe MoneyMe definitely bucks that trend. Despite the majority of its loan book being comprised of personal loans, the average Equifax score for its loan book as of 30 June 2020 was 635, and the median age was 32-years old. This is a sharp improvement from FY19's average Equifax score of 620. This trend is likely to continue. However, this will be more due to the increase, in percentage terms, of its total loan book from ListReady, RentReady and MoneyMe+, rather than a sharp improvement in the company's personal loan book.

To offer a quick explanation of what an Equifax score is, and ignoring the controversy surrounding the system, an Equifax score is what many Australian institutions use to judge an individual's creditworthiness. The system, in theory, has all of an individual's past credit history from phone payment plans to home loans and ranks a score between 0 and 1,200. For an individual with a score between 622 and 725, their credit rating is considered 'good,' while between 726 and 832 is considered 'very good.'

There is a big caveat to keep in mind here; the system can potentially be 'gamed'. MoneyMe could intentionally loan money to a number of individuals with top tier credit scores and potentially skew the average. We assume MoneyMe does not do this. If others do it, it spoils the credibility of the whole space.

We do feel the need to repeat, however, that there has been no indication that MoneyMe has participated in this type of, legal, skewing of its loan book's Equifax average score. Additionally, based on the FY20 provision rate of its loan book being at 9.6%, we find it unlikely that MoneyMe is skewing its loan book's Equifax average score. However, it is something investors need to keep in mind and remain vigilant for when investing in any personal loan company.

MoneyMe has some risk, but markets are underestimating its EBITDA growth trajectory

From an FY22 estimated EBITDA basis, MoneyMe is currently trading at a 22.8x EV/EBITDA ratio. Seeing as the current market consensus is around 70% EBITDA growth annually over the next three years, this seems to be rather cheap to us. We believe the reason for its current discount has, in part, to do with the high level of debt MoneyMe operates with. Yes, we do see the irony. However, this is not unusual for personal lenders like MoneyMe, and with the current interest rate environment, we believe its long-term debt to equity ratio of 85.9% is on the high end of manageable. This does mean, however, that investors should expect to be diluted, equity wise, in the near-term. From a price-to-book perspective, MoneyMe is currently trading at 5.4x and when compared to a company like Commonwealth Bank's 1.9x this seems absurd. However, we would remind investors that MoneyMe is not a pure lending play and has loan book growth over 100% annually. Once again, though, we believe these risks are more than covered by the company's equity share price discount. Therefore, it's a four out of five star rating for us.

Pitt Street Research Pty Ltd

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