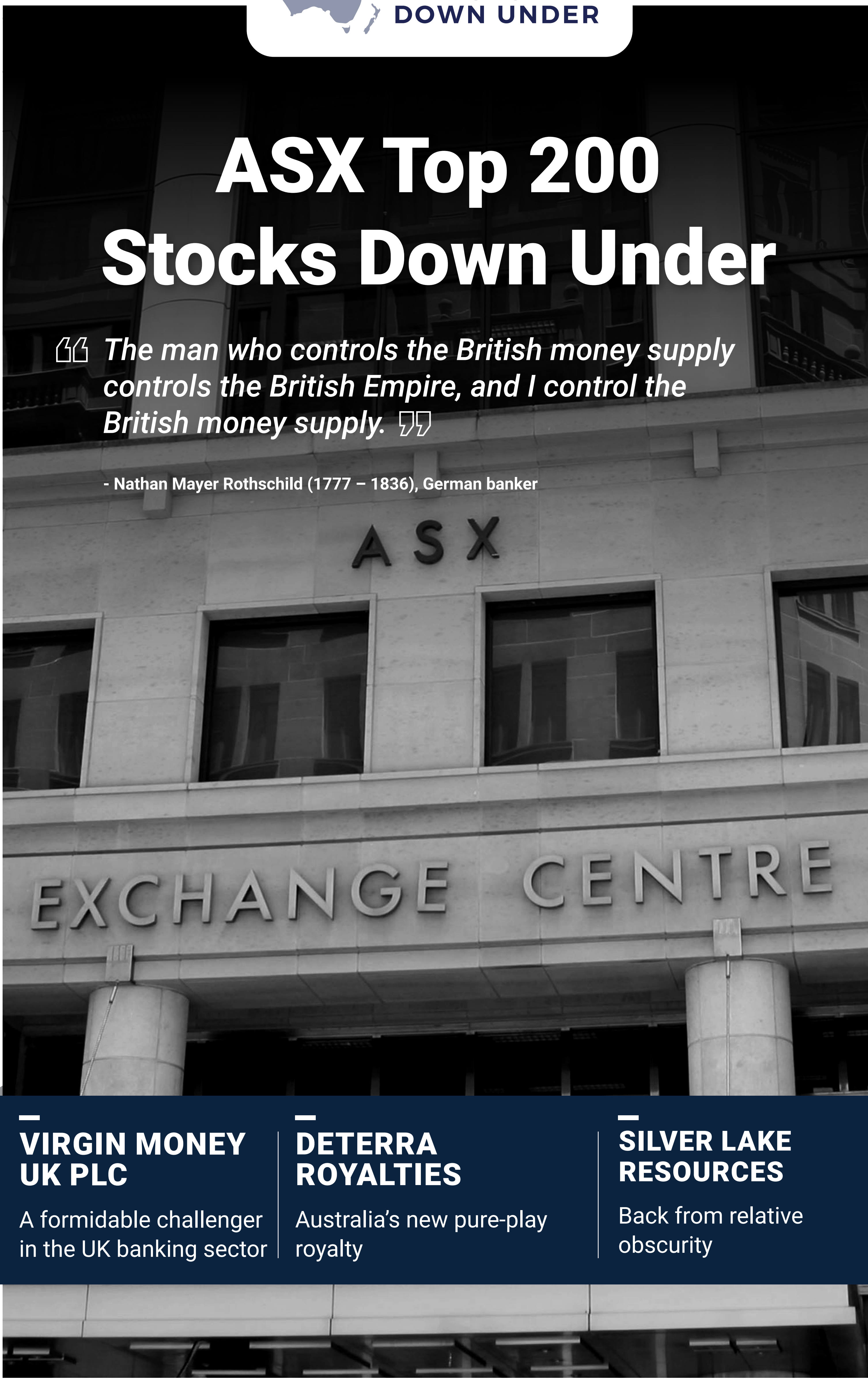
STOCKS DOWN UNDER

4 JANUARY 2021



ASX Top 200 Stocks Down Under

> *The man who controls the British money supply controls the British Empire, and I control the British money supply.*

- Nathan Mayer Rothschild (1777 – 1836), German banker

VIRGIN MONEY UK PLC

A formidable challenger in the UK banking sector

DETERRA ROYALTIES

Australia's new pure-play royalty

SILVER LAKE RESOURCES

Back from relative obscurity

VIRGIN MONEY UK PLC

A formidable challenger in the UK banking sector

Stocks Down Under rating: ★★★★

ASX: VUK
Market cap: A$ 2.2B

52-week range: A$1.06 / A$3.75
Share price: A$ 2.37

Headquartered in Glasgow, Virgin Money UK plc is not your grandparents' banking group. The company offers a wide range of innovative banking and non-banking services that cater to its customers' appetite for convenience. As it transforms into a full capacity digital bank, the group is expected to have new growth opportunities in the post-pandemic world. Virgin Money UK is a fundamentally strong challenger bank that is making waves in a UK financial sector that has been dominated by big players like HSBC, Barclays and Lloyds. We like the company's financial strength and the value of the Virgin Money brand. Despite near-term COVID-19 pressures, the group is well-positioned to benefit from a recovery in economic activity and capture share from traditional banks through its disruptive offerings.

READ MORE

DETERRA ROYALTIES

Australia's new pure-play royalty

Stocks Down Under rating: ★★★★

ASX: DRR
Market cap: A$ 2.5BN

52-week range: A$3.90 / A$5.35
Share price: A$ 4.80

As a spin-off from Iluka Resources (ASX:ILU), Deterra Royalties is one of the first royalty companies of its kind on the ASX. The company's growth revolves around its 1.23% share of Mining Area C ('MAC'), which includes BHP's established South Flank iron ore operations 90km north west of Newman, WA. As a unique pure-play royalty company, we believe Deterra (which means 'from the earth' in Latin) is poised to grow its royalty portfolio beyond iron ore.

READ MORE

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Stocks Down Under rating: ★★

ASX: SLR
Market cap: A$ 1.6BN

52-week range: A$1.05 / A$2.75
Share price: A$ 1.79

Old-timer Silver Lake Resources has had a surprisingly productive year at its two gold operations in WA's Eastern Goldfields district. Despite the good results, shares have slid 16% to $1.69 while investors continue to sell their gold on the back of positive COVID-19 vaccine news, a far cry from the company's July high of $2.66. The company is actively pursuing new exploration and M&A opportunities to cement its position as a mid-tier producer.

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Share price chart

Source: Tradingview

Strategy focused on leveraging the Virgin brand

Formerly CYBG plc, Virgin Money UK plc is the sixth largest bank in the United Kingdom. It was created through the May 2019 merger between CYBG plc and Virgin Money. Today, the company operates through three brands — Clydesdale Bank, Yorkshire Bank and Virgin Money.

Virgin Money UK offers a range of banking services to more than 6 million retail and business customers through retail branches, business banking centres, online channels and brokers. It has a sizeable mortgage lending business in addition to offering business loans and personal loans. We find the smaller credit card business appealing because it is focused on higher quality market segments that have low expected loss rates.

Virgin Money pays the Virgin Group annual license fees to use the globally recognized Virgin brand name. It is in the process of rebranding its largest stores in key UK locations and by the end of next year plans to rebrand CYBG's products to Virgin Money. We believe Virgin Money's brand recognition supports the company's ability to offer banking and lifestyle services in one place. Its banking products are generally more technologically advanced and service-focused than its competitors, which affords customers a greater value proposition. The planned introduction of many non-banking services in a marketplace format has the potential to disrupt a decades old industry and help Virgin Money differentiate itself from traditional banking peers.

Robust capital position

Virgin Money UK's results for the six months to March 2020 were creditable given the challenging economic environment. Although operating income slipped only 3% to £817m, underlying profit before tax fell 58% to £120m reflecting impairments that were about three times what they were in the previous interim period. Both business and personal lending witnessed growth while the performance of the key mortgage business slipped. The underlying return on tangible equity (RoTE) was a decent 4.6% and the net interest margin (NIM) of 1.62% was in line with the company's guidance.

In a time of high economic uncertainty, management has adopted a conservative impairment approach that includes decent COVID-19 provisions. In anticipation of an increase in credit losses Virgin Money UK decided on a £164m COVID provision. This represented 30% of the group's total impairment provisions as at March 2020. It regularly conducts stress test scenarios to assess the adequacy of its impairment provisions and the impact on its capital structure.

We believe the bank is well capitalised to meet any economic challenges that may lie ahead. It has a transitional common equity tier 1 (CET1) ratio of 13.4%. This leaves it with a significant buffer in excess of the 9.5% minimum regulatory requirement. To be fair, this partially relates to the group's recent suspension of dividend payments. Nevertheless, a strong capital position puts the bank in a good spot to absorb potential future loan losses.

Conservative portfolio is economically resilient

About 81% of the group's lending portfolio are mortgages loans with the remainder in business and personal lending. The mortgage quality has been consistently good. Three-fourths of the mortgage assets are owner-occupied. Virgin Money UK has good affordability on these loans as measured by the portfolio's 3x loan-to-income ratio. We also like that only 0.4% of the mortgage portfolio is in arrears compared to an industry average of 0.8%.

Ongoing COVID-19 impacts in the UK continue to make for challenging macroeconomic conditions. Since Virgin Money UK has a large exposure to mortgages and small-medium enterprises (SMEs), its business is significantly linked to the performance of the UK economy. Absent a trading or investment banking business, this makes the bank more vulnerable to an economic downturn as compared to its larger competitors. So, if pandemic conditions worsen in the UK, Virgin Money UK's performance would be negatively impacted.

But overall, Virgin Money's stable portfolio mix helps it have a degree of resiliency to the economic backdrop. Most of the loan book is comprised of secured mortgages with the remainder focused on high quality personal lending and collateralised business loans. This along with the company's strong capital position, brand value and digital growth opportunities in both retail and business banking, make us think depositing some funds in the shares could yield some nice growth. Four stars.

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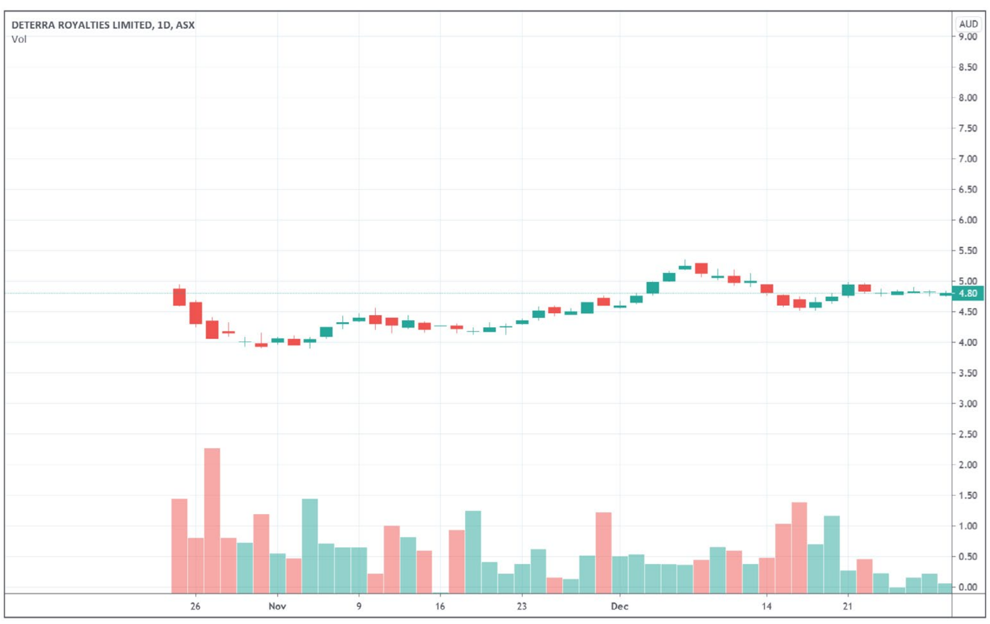

Source: Tradingview

Let's split

Since listing at $4.87, Deterra has already been above $5.00 a share. Part of the appeal of royalty companies like Deterra comes with existing strong (and growing) cash flow from the MAC Royalty zone including BHP's South Flank mine, which is due to start production in 2021 at 80 million tonnes a year. By splitting from Iluka, Deterra is entitled to 1.232% of sales revenue from MAC, meaning that the company generated $48m in 2HY20 from 28.6 million tonnes at an iron price of $87 per tonne.

The other side of that appeal is using that revenue for further investment opportunities both within the MAC area and beyond. BHP has identified two further iron ore deposits within the MAC area at Tandanya and Mudlark as having potential, offering Deterra an add-on to MAC's expected growth to 2023 where iron ore sales are expected to double to 145 million tonnes per year. While royalty companies typically concentrate on previous metals, Deterra is open to value-adding opportunities beyond iron ore.

A novel approach to investing

While other royalty companies, like Horizon Resources (ASX:HRZ) and Gullewa (ASX: GUL), exist on the ASX, Deterra is the first pure-play royalty company. That makes it unique in an Australian context: while royalty streaming is becoming more popular with miners as a way to raise money, pure-plays like Deterra with its scaleable, low-cost structure are much more common in the US. As a non-miner, the company isn't subject to the same operating or capital costs and for the company's investors, the Deterra model is an alternative to direct investing. If anything, Deterra's main risk is based on the strength of iron ore (for now) and not project profitability and risks.

Thanks to all the COVID-19 vaccine news, commodity stocks are rising from their long sleep. While the rush back to commodities after a disaster year could be short-lived, iron ore has a stabilising element in Chinese demand and its move back to domestic production. There's also Brazil's lacklustre year, which could open more windows for Australian ore producers. While fluctuating iron ore prices and exchange rates are still risks for royalty companies like Deterra, the expectation of renewed iron ore production post-COVID-19 offers hope for future opportunities in the sector.

Sit back and relax

While royalty companies overseas are extending their footprint, Deterra could potentially signal a new batch of Australian pure-plays as we become more familiar. As South Flank is forecast to be in production for 30-years plus, Deterra's near-term growth plans revolve around reaping the benefits of the operation. The long term prospective is more interesting: as the company looks beyond iron ore to build its portfolio there is room to move into energy, battery metals and base metals depending on demand and potential. In addition, the company expects strong dividends to flow on from the MAC royalty.

Since Deterra is novel to Australian investors, it will be interesting to watch the company's evolution from single-royalty to multiple-royalty streams. While earnings will depend on iron ore prices and sales volumes, the COVID-19 pressure on iron ore is not expected to substantially hamper the company's growth given the length of the MAC asset. The royalty industry model has rapidly expanded over the last ten years (particularly in the US), but as Deterra so far has no homegrown comparisons, investors will be watching Deterra's potential success in a field of its own. Four stars from us.

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Share price chart

Source: Tradingview

Finally a multi-project outfit again

Silver Lake has spent the last few months transforming the scale and quality of its Deflector Copper Gold Project, located 160 km east of Geraldton in the Murchison region. The underground mine has seen significant mineral resource and ore reserve growth with the integration of the newly acquired Rothsay mine and a plant upgrade via a carbon-in-pulp (CIP) circuit underway to increase gold recoveries. Silver Lake is now planning to introduce Deflector South West lodes to increase mine life and operation value.

Similarly, the company's flagship project at Mt Monger, 50 km southeast of Kalgoorlie, continues to deliver new extension opportunities including the establishment of a new underground operation at the Daisy Complex, and an expected increase in stockpiles at the Karonie South open pit after waste stripping is completed. The amusingly named Mt Belches, with its three shallow underground mines, is another potential drilling opportunity in FY21. Overall, Silver Lake saw its gold production increase by 64% to 274,000 ounces and ore reserves of 1.2 million ounces, a 38% increase.

Riding the wheel of fortune

Like Ramelius Resources, Silver Lake has taken an acquisitive stance since its inception in 2008, but that hasn't always paid dividends. When the company took over Integra Mining in 2013, Silver Lake became one of the top five producers in Australia, with a 6.6 million ounce resource base and a forecast production of over 400,000 ounces per annum in 2014. Despite a $1bn market cap and a 100,000 per annum gold operation at its Murchison Project, the company was kicked off the ASX 200 following its declining cash position from Murchison under previous managing director, Les Davis. Silver Lake eventually mothballed the Murchison operation and closed its Lakewood mill in June 2014.

The Integra deal was a saving grace for the company in that it allowed much greater focus on Mt Monger, but it left Silver Lake lacking some relevance in the context of M&A (mergers and acquisitions). The decision to merge with Doray Minerals (another multi-mine to single project story) in 2019 gave Silver Lake not only Deflector, but a place back in the ASX 300. Given the merger was only completed in January 2020, revenue guidance has been updated twice in FY20, making this the sixth year that the company has met or exceeded its targets. Deflector may turn out to be a turning point in Silver Lake's journey back to top gold dog as the South West corridor has the capacity to extend the mine life as well as enhance returns from the CIP circuit. The new lodes are of a higher quality of gold and copper, accounting for almost 35% of the Deflector ore reserve.

Overshadowed by 2020 juniors

Silver Lake's current financial position highlights its smooth roll towards ore reserve growth and cash reserves, but its achievements seem largely overlooked in a year where investors were much more excited about up-and-coming junior gold explorers. The company strengthened its cash position to $34m during the September quarter to $303m, with $6.6m invested in exploration. This allows Silver Lake to continue its momentum with upgrades at Deflector and Mt Monger.

Considering its earliest difficulties, the company appears to have regained its position in WA's gold industry despite a major pandemic and an otherwise volatile gold market. Not content with lurking behind busy juniors, Silver Lake has hinted at a FY21 sales guidance of 240,000-250,000 ounces at an average AISC of $1,400-1,500 with a further $21m budgeted for extensions. About the only thing wrong with this story right now is the gold price, which is why we're giving it two stars. Once gold stabilises, alongside the Australian dollar, four will be a better number.

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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.