STOCKS DOWN UNDER

12 APRIL 2021

ASX Top 200 Stocks Down Under

Conquering the world on horseback is easy; it is dismounting and governing that is hard.

- Temuchin aka Genghis Khan (1162 – 1227), Founder of the Mongol Empire

ASX

EXCHANGE CENTRE

NATIONAL AUSTRALIA BANK

On the road to recovery

CHAMPION IRON

A blooming opportunity for Canadian iron ore

HUTCHISON TELECOMMUNICATIONS (AUSTRALIA)

Not our kind of business

NATIONAL AUSTRALIA BANK

On the road to recovery

Stocks Down Under rating: ★★★★

ASX: NAB
Market cap: A$ 88BN
Dividend yield: 2.3%

52-week range: A$15.00 / A$27.10
Share price: A$ 26.72

The last time we checked in on Melbourne-based National Australia Bank, the share was trading at a 20-year low. Fast forward ten months and NAB had climbed 60%—and is on the verge of returning to where it was before the COVID-19 outbreak caused the floor to drop from underneath. We expect Australia's leading business bank to continue to benefit from the economic recovery, investments in digital banking and a focus on its core business.

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CHAMPION IRON

A blooming opportunity for Canadian iron ore

Stocks Down Under rating: ★★★★

ASX: CIA
Market cap: A$ 3.1BN

52-week range: A$1.72 / A$6.25
Share price: A$ 6.10

Since restarting its Canadian flagship Bloom Lake iron ore mine in 2018, Champion Iron's stock has risen 3,000%. Bloom Lake is the latest attempt by the company to bring back idled mines from the dead and so far, it's been a total success with record production and revenue. Still, Champion is now pressured to scale up the project commensurate to its previous profitable ventures. A winning production at Bloom Lake could see the company expand its Canadian portfolio all the way through Quebec as it strives to make one more company-maker.

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52-week range: A$0.12 / A$0.20
Share price: A$ 0.13

Headquartered in Sydney is Hutchison Telecommunications, a company currently trading at $0.13 per share, but with a market capitalisation of over $1.7BN. The company effectively operates as a holding entity for a significant TPG Telecom investment following its merger with Vodafone Hutchison Australia. The company also owns a significant portion of Vodafone Hutchison. Should we see Hutchison Telecommunications as a proxy for owning TPG shares and Vodafone.

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Share price chart

Source: Tradingview

Short-term pain, long-term gain

National Australia Bank caters to consumer, business and wholesale banking customers. Its offerings include standard deposit and loan products in addition to insurance and wealth management. Although its business is well diversified, small and medium-sized businesses are its strength. NAB controls roughly 25% of Australia's small business market. This leadership gave us the gumption to award a four-star rating in May 2020 when few wanted to touch the stock.

COVID-19 issues dragged down the FY20 result with lower income from loan repayments being a challenge. Underlying profit fell 4.1% to $9.64bn. Both business loan and mortgage loan performances negatively impacted results, especially in the retail, travel, hospitality and commercial real estate sectors. We consider the repayment pauses to temporarily affect NAB and see the bank getting stronger as the Australian economy continues to recover. Plus, the Reserve Bank of Australia (RBA) is likely to keep rates low to support the big banks' ability to lend to businesses and consumers.

So, while the FY20 financial result wasn't great, this was largely expected. More importantly, NAB's balance sheet strength was maintained despite the extraordinary economic circumstances. Plus, we like to think the company earned some long-term goodwill because of all the support it provided to homeowners and businesses during a tumultuous time.

Going digital

Perhaps we got a sneak peak of this goodwill in the group's 1Q21 trading update. NAB's net promoter score for December increased by one point, giving it the number two ranking among major Australian banks. The financial performance was also encouraging. Cash earnings were up 47% in the quarter primarily due to increased business banking activity and a slight decrease in expenses. On the negative side, the bank's portion of loans 90+ days past due and assets impaired increased to 1.2% in January 2021, showing that the pandemic's effects are still very real for many business owners and consumers.

NAB's personal banking side continues to progress with its digital strategy, which seems to be a must-have for businesses in most sectors these days. As part of the IT upgrade, NAB is also migrating its technology applications from legacy systems to cloud computing environments to enhance software reliability and lower costs.

We also favour the company's narrowed focus on its core competencies. It has shortened its banking product menu and cut out many annoying fees, much to customers' liking. Most of NAB's consumer product sales take place on its digital platforms these days, showing that you can indeed teach an old dog new tricks. We see good upside from consumer banking clients continuing to embrace NAB's simple digital loan process.

As part of its plan to shed non-core assets, on 31 August 2020, NAB announced a deal to sell its MLC Wealth Business to Melbourne-based investment firm IOOF Holdings (ASX: IFL) for $1.44bn. This was a big step towards regaining focus on the core banking business and will result in a nice payday for the balance sheet. The transaction is expected to be completed by the middle of this year.

The yard sale continued on 16 December 2020 when NAB announced an agreement to sell its BNZ Life Insurance unit to New Zealand's Partners Life for NZ$290m. This deal is forecast to close towards the end of 2021.

Then, on 29 January 2021, the bank moved to the negotiation table's buyer side in agreeing to acquire Australian neobank 86 400 for $220m. This move was designed to accelerate growth in the UBank digital banking division, becoming a bigger part of the business.

Strong capital position

NAB's resilience during the pandemic has been reflected in its high level of capital adequacy. As of 31 December 2020, the common equity tier 1 (CET1) was 11.7%, the highest it has been in a long time. This cushion will help the company absorb lingering credit losses related to the pandemic or an unexpected economic setback.

Management has done a nice job of juggling balance sheet strength and rewarding loyal shareholders with dividends. Although it did decide to pare back the dividend (to the tune of 64% in FY20), the share's historically depressed price means a respectable 2.3% yield is up for grabs. We expect the low dividend payout to gradually increase as operating conditions normalise and NAB returns to delivering strong results similar to those of FY19.

The potential for rising interest rates and a higher net interest margin (NIM) also bodes well for future earnings. So, it's still four stars from us.

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Source: Tradingview

Bloom Lake back at work

Bloom Lake, located 13 km north of Fermont, Quebec, is one of many high-grade iron ore projects situated within the southern Labrador Trough, Canada's largest source of iron ore. Bloom Lake is just one of a portfolio of Canadian projects the company is planning to develop – including the recently acquired Fire Lake North Project. But the flagship project is poised for further growth following the 2019 updated Feasibility Study, which will see reduced capital costs and a doubling of capacity. Champion has already exceeded expectations with the mine amidst a volatile iron ore price: after acquiring the idled mine from US mining company Cliffs Natural Resources in 2015, the company spent $124m restarting the mine in 2018 and produced a record 2.27 million tonnes that year.

Prior to Champion's Phase 1 recommission, Bloom Lake had a mineral reserve of 411 million tonnes at an average iron (Fe) content of 30%, but the company's updated Phase 2 Feasibility Study outlines a mineral reserve of 807 million tonnes and a nameplate capacity of 15 million tonnes per annum from 7.4 million tonnes per annum (at 66.2 Fe). Because Fermont is relatively isolated – the site is 1,200 northwest of Montreal – Champion is focused on expanding its distribution routes with a new multi-user berth at the

Port of Pointe-Noire as an addition to the Port of Sept-Iles, all the way south to the Gulf of St. Lawrence. The company's slowly expanding portfolio from Canada's safe, high-grade jurisdiction is key to providing concentrate to customers in Asia, the Middle East and Europe

Champion brings its own track record of success

Bloom Lake's quick ascent back to a record-producing mine can be partially credited to the bearish switch up in iron ore pricing, which at the time of Cliffs parting, was a miserable US$40 per tonne. But it's more than a case of good timing. When Champion acquired the project for C$9.7m, it came as a fully-established mine with infrastructure and mining work by previous work worth US$3.7bn – a good deal by any standard and especially good for a junior. That existing work, combined with solid pricing and low freight prices has allowed Champion to adapt very quickly over the last two years, producing 7.9 million tonnes of 66.2 Fe concentrate in the 2019-20 financial year. And while the operational capacity continues to improve, Phase 2 also reflects an improvement in capital and operating costs. At the expansion programs completion in mid-2022, Champion is looking at a CAPEX of US$589m and a cash cost of US$35.4 per tonne compared to Cliffs' original numbers of US$1.2bn and US$82 per tonne.

Even before the expected completion of Phase 2 works in mid-2022, the 2021 third quarter provided strong income and cash flows including a revenue of $329m, a record EBITDA of $211.9m and cash flow of $185m, so it comes as no surprise that the company's share price has grown from 20 cent in 2016 to $6.00 this month. That uplift in the share price also comes with high expectations for Bloom Lake as a potential sale. The company's executive chairman, Martin O'Keefe, has a history of taking failing mines and turning them into money-makers, such as Rio Tinto's Riversdale mine. Now that Bloom Lake has a Phase 2 extended life of mine of 21+ years with a total revenue of C$15bn and a combined Phase 1 & 2 Net Present Value of C$3.78bn (8% discount) and an Internal Rate of Return of 33%, the project could be one of a long line the company will build up and sell off. Champion is in the final stage of acquiring the Kami Project from Alderon Iron Ore, only a few kilometres south east of Bloom Lake. 7.8 million tonne Kami would help the company secure an additional eight million tonnes per annum in port capacity and provide additional footing for future growth.

A pipeline of Bloom Lakes

In the longer term, Champion wants to develop its 9.3 million tonne Fire Lake North Project (40 km south of Bloom Lake), but that project will require a great deal more infrastructure work than necessary at Bloom Lake, meaning it will likely take a backburner to Kami. Fire Lake has similar fundamentals to Bloom Lake with 9.3 million tonnes and a 19-year mine life, but the last study was done in 2013. As if the acquisition opportunities in Fermont were not enough, the company's exploration-stage projects south of Fire Lake – Moire Lake, Harvey Tuttle and O'Keefe-Purdy – have substantial resource potential as well.

More than anything, Champion is looking to add value to the iron ore chain by producing high-grade concentrate to compete with Brazil for customers. The company sells its product mainly through Japanese company Sojitz and Glencore, so the additional port space is fundamental to the production capacity expected.

With a strong financial position with cash reserves of $500m, the future looks bright for Bloom Lake, but Champion will be concentrating on the next iron ore price fluctuation. Four stars.

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Share price chart

Source: Tradingview

The main assets are TPG

On 11 August 2020, we at Stocks Down Under wrote about TPG Telecom. This was a newly formed entity following the merger between Vodafone's Australia operation and TPG Telecom in late June 2020. Hutchison currently owns 11.14% of the ASX-listed TPG entity and 50% of Vodafone Hutchison (Australia) Holdings Limited in the United Kingdom. Unfortunately, we are pessimistic on this new TPG entity. In fact, we currently have a two-star rating on the stock. This comes down to three main factors: EBITDA, subscribers and competition.

TPG has a market capitalisation of $11.8bn, making Hutchison's equity portion worth approximately $1.3bn. As TPG is one of the top ASX 200 companies, it is heavily followed by analysts. Currently, the market expects TPG to see EBITDA growth of around 8% during FY22 and 7% during FY23. This low EBITDA growth rate is due to EBITDA margins that continue to be squeezed through increased competition and difficulty acquiring new subscribers and keeping the existing ones. The increase in competition in the Telco industry is directly responsible for these troubles. Unfortunately for TPG, as it is an incumbent, we believe things will continue to get more difficult. TPG's FY22 and FY23 EV/EBITDA ratio is 8.8x and 8.1x, respectively. As Hutchison's market capitalisation is based almost exclusively on its holdings in TPG, we do not believe this is positive for Hutchison shareholders going forward.

Liquidity and float are massive risks

On top of our concerns around TPG, Hutchison itself has some major risks attached. The first is its almost non-existent trading liquidity. Over the last three months the average number of shares traded was only 270,000 per day. Using Friday's closing price, that amounts to a tiny $35,100 in daily traded value. This means that getting into the stock is likely to be difficult, but getting out in the case of any negative news is likely to be even harder.

To make the liquidity situation worse, it is doubtful that it will ever be resolved, because Hutchison's free float is only 1.1%. The reason for this low free float is rather straight forward: CK Hutchison Holdings own 87.9% and Spark New Zealand owns 10%. CK Hutchison Holdings is a Hong Kong-listed holding company involved in retail, telecommunication services and infrastructure development. As of the time of writing, this company has a market capitalisation of US$31.3bn. Neither of these corporations have shown an interest in potentially divesting part of their stakes.

A poor holding to own

We are not fans of Hutchison. We see no reason why individuals who are interested in TPG would not just buy TPG shares directly. And the daily trading liquidity of TPG over the last three months is 1.2m shares on average, or a value of $7.6m. On top of the significantly higher liquidity levels, TPG has an indicative dividend yield of 1.2% annually. However, we're not fans of TPG to begin with, so why own shares, directly or indirectly, in the first place. Two stars from us.

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