STOCKS DOWN UNDER

10 MAY 2021

ASX Top 200 Stocks Down Under

"Everyone has access to information – we just know how to analyse it better."

- Bobby Axelrod (Billions), American TV show character

ASX

EXCHANGE CENTRE

FORTESCUE METALS GROUP

Declining iron ore price forecast looms large

WOODSIDE PETROLEUM

LNG recovery play

XERO LTD

Subscription base is growing, but so is the valuation

FORTESCUE METALS GROUP

Declining iron ore price forecast looms large

Stocks Down Under rating: ★★

ASX: FMG
Market cap: A$ 70BN
Dividend yield: 11% (100% Franked)

52-week range: A$11.17 / A$26.40
Share price: A$ 22.99

Since we last wrote about -based Fortescue Metals Group on 2 March 2020, the miner's share price dug itself out of its pandemic low and climbed to a record high above $25. It has since declined approximately 20% with the market deciding the iron ore producer was in the smelter for too long. We think there may be more downside to come based on an unfavourable long-term outlook for iron ore prices.

READ MORE

WOODSIDE PETROLEUM

LNG recovery play

Stocks Down Under rating: ★★★★

ASX: WPL
Market cap: A$ 22BN
Dividend yield: 2.2% (100% Franked)

52-week range: A$16.80 / A$27.60
Share price: A$ 23.24

Since we last wrote about Perth-based Woodside Petroleum on 22 June 2020, the company was picking itself off the ground after oil and LNG prices crashed. Its share price dipped below $20 before recovering on a better outlook for oil and gas demand. Still, the stock is trading roughly where it did five years ago and has room to run, in our view. A healthier LNG export market and increasing production targets make Woodside a share we'd want on our side as the recovery unfolds.

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52-week range: A$75.00 / A$157.99
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On 29 May 2020 we lauded Wellington, New Zealand-based Xero for its innovative accounting products, but felt uneasy about the valuation. In hindsight, we were half-right, but unfortunately, not about the rating part. Despite Xero's recent growth, we still feel its valuation doesn't add up. Even after correcting 22% from its record high, we have zero interest in paying a premium price for Xero.

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Share price chart

Source: Tradingview

Party may be winding down

Fortescue Metals Group is the world's fourth largest iron ore producer with mining and exploration assets in the Pilbara region of Western Australia. With iron ore at the core of the business, Fortescue's financial performance is predominantly tethered to iron ore pricing. Our readers will recall that in 2019, the Brumadinho disaster in Brazil led to a spike in iron ore prices after Vale suspended operations, drastically shrinking the global iron ore supply. By November 2019, however, prices were trimmed by about one-third on weakening demand trends. Then just as pricing began to recover, COVID-19 came along and pushed iron ore back down to the US$80 per tonne level in April 2020.

The recovery in pricing since then has been nothing short of spectacular. Iron ore has more than doubled over the past 12 months and may be closing in on its highest level since 2011. Iron ore cargo deliveries are now going for around US$165 per tonne at Tianjin thanks to an increase in automotive industry and infrastructure activity while supply has remained limited. Prices have come down from their 4 March 2021 peak due to environmental challenges in Tangshan, China's big steel producing city, and expectations that Vale will return to normal production levels by the end of this year. But we expect iron ore prices will be supported in the near-term by the latest manufacturing data in China (the world's top steel producer) and optimism around the global economic recovery.

So, what does this mean for Fortescue? The group is certainly in a stronger pricing environment than it was a year ago. This could lead to some favourable near-term results. But Fortescue and its iron ore peers may want to enjoy it while it lasts. This is because iron ore prices are widely expected to trend lower over the next couple of years. In February 2021, Commonwealth Bank of Australia said it expects iron ore prices to remain elevated in the first half of CY21 due to China's fiscal stimulus. Soon thereafter though, CBA sees prices "falling more sharply" as the stimulus buzz turns into a hangover and China makes growth in commodity driven sectors less of a priority. CBA's forecast is for spot prices to dip to US$100 by the end of this year, US$90 by the end of 2022, and US$70 by the end of 2023. We tend to agree with this assessment and see softer demand and increased supply weakening Fortescue's profits in the coming years.

Strong results won't last

Now that we have a good sense of where iron ore and Fortescue may be heading, let's take a step back and review its recent results—and where Fortescue management thinks it is headed.

In FY20 the group shipped 178.2m tonnes or iron ore at an average realised price of $US79 with the latter up 21% from FY19. This drove a 29% increase in revenue to US$12.8bn and a 49% jump in net profit after tax (NPAT) to US$4.7bn both of which were record amounts. Strong Chinese demand for iron ore imports for steel production in conjunction with low iron ore stocks in Australia and Brazil drove the result. In other words, demand outran supply leading to higher pricing and a strong FY20 result.

The 1HY21 result told a similar tale of higher realised prices, revenue and profits. Realised prices rose 42%, revenue was up 44% to $US9.3bn and NPAT increased 66% to US$4.1bn. Management understandably decided to strike while the iron was hot in giving an upbeat view on FY21. Expecting to capitalise on the stronger pricing environment and based on its efforts to debottleneck its mining operations, it increased FY21 shipment guidance to a range of 178m to 182m tonnes. It's hard to argue with this enthusiasm, but as you can tell by now, we don't see the good times rolling much beyond the 2HY21 result.

Iron Bridge may take a toll

At the same time as the 1HY21 report (18 February 2021), Fortescue provided an update on its review of the Iron Bridge magnetite project. Iron Bridge is Fortescue's joint venture with Taiwan-based Formosa Steel that is expected to deliver 22m tonnes or iron per annum that can be used as pellet feed or for blending with sinter fines. The group concluded that the project will require additional capital of up to US$3bn and that production will begin in the second half of CY22. Fortescue has already invested more than US$1bn in the project. As you can imagine we have concern over the timing of the planned production given the forecast for iron ore prices and its potential to further increase the global iron ore supply.

In terms of valuation, Fortescue looks dirt cheap based on FY22 earnings expectations at 8.6x. But as the impact of a declining iron ore price forecast start to be factored in, the P/E multiples go to 12.6x for FY23 and 18.1x for FY24. So, while Fortescue shares may benefit from a perception of being undervalued in the short to medium term, we don't consider it to be an attractive long-term commodity play. A more diversified mining company, like Rio Tinto, that isn't so dependent on iron ore would be a better choice, in our view. Fortescue gets two stars from us.

WOODSIDE PETROLEUM

LNG recovery play

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Share price chart

Source: Tradingview

CEO opening

Woodside Petroleum is Australia's largest oil and gas producer. Although it owns assets in both commodities domestically and internationally, the liquid natural gas (LNG) business is the fuel behind its financial performance. Historically, LNG has accounted for over three-fourths of annual revenue and in 4Q20 it accounted for 68%. This isn't to say that oil pricing plays a minor role in Woodside's fortunes. In fact, oil and LNG prices tend to move somewhat in tandem. WTI Crude oil prices are at US$65.01, a level that few expected just 12 months after the Corona Crash. Meanwhile, spot LNG prices are hovering around record highs.

Despite producing a record 100.3m barrels of oil equivalent (boe) in FY20, the weak energy market led to a US$4.0m net loss. COVID-19 and Tropical Cyclone Damien presented volume losses and operational challenges that were too much to overcome. The bottom-line performance was weak as expected, but we were encouraged by how operating conditions improved as the year progressed. The Scarborough LNG project (off the coast of Karratha) is moving along well after the contracted gas level increased to 50%, and first production is still on track to start during 2HY21. The capacity of the project was also increased by 20% to 8m tonnes of LNG per annum. The first LNG cargo is slated for 2026, so this is a long-term growth project, but one well worth the wait, in our view.

A major development late in 2020 was the announcement of the planned retirement of CEO Peter Coleman. Mr. Coleman will be sailing off into the sunset in the second half of 2021 after ten years in the position. We never fault a man for choosing to retire, but have concern over the leadership void and uncertainty around a successor. Woodside has begun an internal and external search for its new leader.

Sangomar stake raised

A big part of Woodside's growth strategy is the Sangomar field, a narrow sandbar located in the Atlantic Ocean off the coast of Senegal. Woodside is the operator of the joint venture with FAR Limited and Senegal's Petrosen. In August 2020, Woodside more than doubled its interest in the development to 68% after acquiring a large stake from UK's Cairn Energy PLC. Then in December 2020, Woodside increased its stake to 82% after it acquired FAR's interest in the exploitation area.

The field, located 2km below the seabed floor, is Senegal's first offshore development and contains both oil and gas. Oil production is expected to start during 2023, with approximately 231 million barrels targeted during phase one. The plan is to install a stand-alone Floating Production Storage and Offloading (FPSO) facility that can export gas to Senegal and eventually will have subsea tiebacks to other oil and gas fields in the region. We like Woodside's aggressive move in taking a majority stake in Sangomar plus the fact that it will be value accretive to shareholders.

Speaking of value-added moves, Woodside recently signed a pair of long-term LNG supply agreements. On 18 January 2021, it expanded its 13-year contract with Germany's Uniper by doubling the amount of LNG that Woodside will supply to 2mtonnes per annum (tpa). Then on 19 February 2021, it inked a new seven-year deal with Germany's RWE Supply & Trading to supply 0.84m tpa starting in 2025. Back in October, Woodside and RWE also signed a memorandum to discuss hydrogen-related opportunities. As a carbon-neutral fuel, hydrogen is expected to play a bigger role in clean energy development and could be a boost Woodside's future growth.

Valuation looks good

Woodside's balance sheet and liquidity position continue to stand out among its oil and gas peers. As of 31 December 2020, gearing was 24.4% and it had $6.7bn of liquidity. This puts it in a good position to capitalise on growth opportunities as energy markets recover. Of course, the pace at which it pursues these opportunities will largely depend on where oil prices go from here.

If the pace of the global economic recovery is as rapid as anticipated, demand from industrial firms and gasoline consuming travellers should be strong. OPEC supply actions are harder to predict, but recent actions have kept production at supportive levels. The company has been bringing production back online to cope with rising demand. We see oil prices continuing to recover with economic activity and low-cost producers, like Woodside, benefitting. In FY20, Woodside's production cost was a low US$4.80 per boe (versus an average realised price of US$32/boe).

Woodside shares are trading at 13x FY21 earnings and at an EV/EBITDA multiple of 5.9x. Both valuation metrics suggest there is good value here. Even though EBITDA growth will moderate compared to the huge jump expected from FY20 to FY21, the price is still attractive considering operating margins are forecast to trend higher over the next few years (from 41.7% in FY to 44.7% in FY23).

We also see upside potential to the dividend as operating cash flow continues to improve, making this an even better value play. If LNG demand and pricing continue to remain firm, Woodside's financial results should recover, so we see considerable upside in this four-star share.

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Share price chart

Source: Tradingview

Elevated cloud accounting demand

Xero provides business and accounting software for accountants, bookkeepers, and small-to-medium-sized companies, mostly in Australia and New Zealand. As businesses have scrambled for any increase in efficiency during the pandemic, Xero's products have experienced strong demand. Customers have increasingly embraced the technology to eliminate headaches caused by the overly complicated software suites of Xero's competitors. At Stocks Down Under, we use Xero's accounting software.

There's no denying that Xero's software solutions make life easier for busy executives who are better served focusing on what they do best—like equity research. They easily integrate with a firm's technology platforms, such as banking and payments. The result is a seamless integration of a company's financial data with Xero's user-friendly accounting software. Since Xero customers can have a comprehensive financial picture from sales data to tax information, they find it hard to part with Xero once it's integrated with their systems. Xero's current ecosystem includes more than 800 third-party apps and over 200 connections to banks and other financial institutions.

Knowing how sticky its customer base is, Xero has set its sights on vertical expansion, i.e. growth opportunities in complementary markets. On 25 August 2020, it announced a plan to enter the lending business by acquiring Sydney-based Waddle for a total potential consideration of $80m. Waddle offers a

cloud-based lending platform through which small businesses can attain capital via invoice financing. When a business borrows against funds due from customers, it can pay its bills and reinvest in growth without waiting around for invoices to be paid. We see the Waddle acquisition as a natural progression in Xero's strategy to address small businesses' financial needs.

Subscriber base, product suite expanding

The 1HY21 result was impressive and sparked the stock's rally to an all-time high. For the six months ended 30 September 2020, revenue was up 21% to NZ$409.8m. Despite facing some hurdles in acquiring new customers during COVID-19, Xero's subscriber base increased 19% to 2.5m, with growth occurring in all regions. Customers are not only being added, but are paying more by upgrading to premium subscriptions and adding extra software tools. This was reflected in Xero's total subscriber lifetime value (LTV), a measure of how much the average customer will spend over the course of the relationship, which rose 15% to $6.2bn. With this said, average revenue per user (ARPU) did slip 4% in 1HY21 to NZ$29.81. While not a great stat, we are not concerned considering Xero likely enticed would-be subscribers with free trial memberships.

One area that is a bit more concerning is the NZ$140m spent on product development in 1HY21, a 29% increase year-over-year. At this rate, it outpaced the 21% revenue growth rate. This may be a temporary matter stemming from the growth opportunity at hand, but is nevertheless something worth monitoring. On the plus side, sales and marketing expenses fell 10% in the interim period, and customer churn was a stable 1.1%.

Xero was fresh from the deal-making table again on 4 March 2021 when it announced the acquisition of Denmark-based Planday for up to €183.5m. Planday operates a workforce management platform that helps small businesses manage scheduling in order to increase efficiency and reduce labour costs. Over 350k employees in the UK and Europe use cloud-based Planday's services to see when they are scheduled to work. We see the Planday addition as yet another 'plug-in' growth lever that can increase sales to existing customers and bring in new customers. Although the acquisition is forecast to have a slightly negative impact on FY22 EBITDA, this should be a nice addition to Xero's SaaS revenue machine over the long run.

Even more expensive

Xero still has a large, untapped market that it can grow into. During the interim period, Australia became its first market to reach the 1m subscriber mark. While growth opportunities remain here, the much larger sizes of the UK and North American markets suggest the runway to subscriber gains there is quite long.

Still, the most compelling aspect of an investment in Xero is the recurring nature of the company's revenue. Since it operates a software-as-a-service (SaaS) model, most sales are in the form of monthly subscriptions. This provides the kind of revenue stability and visibility that investors appreciate.

What we don't like about Xero is its valuation. After advancing nearly 90% over the last 12 months, the share trades at astronomical valuation multiples. The EV/EBITDA is 84x for FY22 and 61x for FY23 on consensus EBITDA-growth of just 11.6% for FY22 and 38% for FY23. In our book that makes Xero substantially overvalued.

So, once again we give a positive review of our personal experience with Xero as well as where the company is heading with its growth strategy. We swallow our pride as we admit we got it wrong last year with a 2-star rating. However, last year and also at current valuation we couldn't bring ourselves to buy Xero, so we wouldn't recommend anyone else to.

We continue to believe there are more attractively valued shares out there for long-term growth investors. A more pronounced pullback would be needed for us to book a value of more than two stars for Xero.

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