STOCKS DOWN UNDER

17 MAY 2021

ASX Top 200 Stocks Down Under

> *Never underestimate the power of human stupidity.*

- Robert A. Heinlein (1907 - 1988), American naval officer

BHP GROUP

Copper prospects are shiny, but the valuation is too shiny

RIO TINTO

Better commodity pricing but it won't Last

FISHER & PAYKEL HEALTHCARE

Healthy growth prospects, but unhealthy price

BHP GROUP

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Stocks Down Under rating: ★★

ASX: BHP
Market cap: A$ 148BN
Dividend yield: 4.1%

52-week range: A$30.57 / A$51.82
Share price: A$ 49.59

It's been over a year (18 December 2019) since we last wrote about Melbourne-based BHP Group and much has changed in the mining industry. Production halts and demand weakness has given way to increased production and optimism towards an economic rebirth. With commodity prices now on the rise, BHP is well-positioned to benefit from a more robust trading environment. However, with the share price at its highest level in 10 years and the valuation stretched, we prefer to dig for value elsewhere.

READ MORE

RIO TINTO

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Stocks Down Under rating: ★★★

ASX: RIO
Market cap: A$ 48BN
Dividend yield: 5.7%

52-week range: A$82.94 / A$132.94
Share price: A$ 125.61

Back on 10 April 2020, when we last wrote about Melbourne-based Rio Tinto, the impacts of the pandemic were weighing on the company's financial performance. A year later, government stimulus and an improving economic landscape have set the stage for higher metals demand and stronger results. With operating conditions normalising across Rio Tinto's markets and commodity prices recovering, the share is looking more interesting. But based on expectations of lower prices ahead, we believe the window of opportunity is limited.

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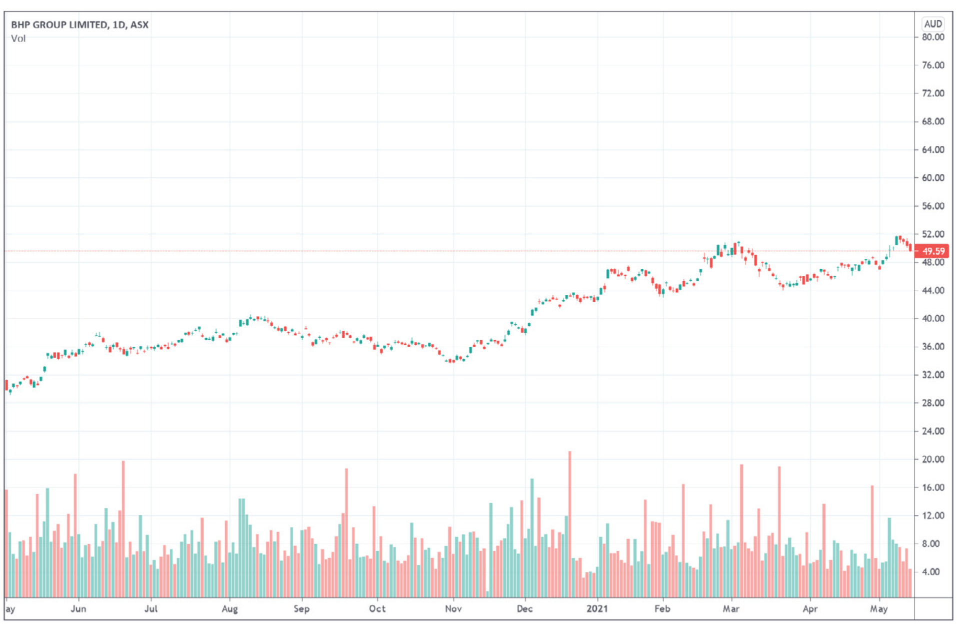
Share price chart



Source: Tradingview

Supply-demand dynamics improving

BHP Group is one of the world's largest natural resource companies with a massive portfolio of metal and energy assets. In addition to being one of the top producers of iron ore, copper, nickel and metallurgical coal, it has significant interests in oil, gas and energy coal. It also has a small potash business that may soon become larger thanks to an improving global agriculture industry.

Given the nature of the beast, the share is highly exposed to commodity pricing, which comes down to the good old economic principle of supply and demand. The impacts of COVID-19 wrangled both the supply and demand sides of the equation in 2020. A sharp slowdown in industrial activity and a reduced need for energy in the early stages of the pandemic weighed heavily on commodity demand. At the same time, mine closures and restrictions as well as oil and gas supply chain constraints crippled commodity supply. This perfect storm created a dismal environment for the BHPs of the world for most of CY20.

Fortunately, the new year has rung in a reversal of fortunes for BHP and its commodity-linked peers. Automobile assembly lines and infrastructure projects are revving back up—and along with it, demand for metals, oil and gas. Meanwhile, supply challenges have mostly faded, lifting commodity prices and providing much healthier trading conditions for BHP.

The great copper hunt

Speaking of major changes, BHP ushered in new leadership in 2020, a change we've felt is reason for caution. CEO Mike Henry now has his first calendar year under his belt as BHP's new leader and has thus far taken a conservative stance on growth and gearing. However, with FY22 getting closer and the group's 22% ROCE target in the crosshairs, it remains to be seen if Mr. Henry can step on the gas to give BHP a higher risk profile.

We believe the leadership change couldn't have come at a more unfortunate time, with COVID-19 throwing a major curveball at BHP. Overall, though the group showed resilience as a weak back half of the year dragged down FY20 revenue by only 3% to US$42.9bn. The pandemic had a financial impact of US$348m and contributed to an 8% net profit after tax (NPAT) decline to US$8.0bn. This reflected lower production volumes, temporary shutdowns, relocation expenses and safety costs.

An interesting development during CY20 was BHP's announcement of a partnership with Australian mineral exploration company Encounter Resources Ltd. There are Easter egg hunts and then there are copper hunts. In this case, the goal is to hunt for copper at the 4,500km Elliott Copper Project in the Northern Territory. BHP agreed to spend as much as $22m over the next ten years for a stake up to a 75% in the joint venture. Elliot is considered a high quality, high potential copper region located in the Beetaloo Basin. Given surging copper prices and the strong long-term demand for copper to support electric vehicle development globally, a major copper discovery there could be a big growth catalyst for BHP.

Rio's valuation and yield are more attractive

The 1HY21 result contrasted with the FY20 performance as signs of the global economic recovery became more apparent. For the six months ended 31 December 2020, revenue was up 15% to US$25.6bn. The NPAT result was less encouraging, down 20% to US$3.9bn. This was not so much due to COVID expenses, but rather the impairment of the New South Wales Energy Coal (NSWEC) business as well as the labour strike at the Cerrejon coal mine in Colombia. On the bright side, underlying profit increased 16% to US$6.0bn, which is where the higher commodity prices came into play.

BHP released its nine months FY21 production figures on 21 April 2021, and its guidance stayed mostly in line. The two changes were copper guidance increasing to 1660kt from 1535kt and metallurgical coal guidance reducing to 39mt from 41mt for FY21. BHP's guidance for FY21 petroleum and iron ore production remained unchanged.

The group currently has four major development projects in the works, including the Spence Growth Option, a new concentrator plant that is expected to produce 185k tonnes of copper per annum over the next ten years. The plant saw its first copper production in December 2020.

BHP's dividend yield is attractive at 4.1%, but yield isn't everything as we've learned over the years. What's not so attractive is the share's valuation. At 11.7x consensus FY22 earnings, BHP trades clearly higher than Rio Tinto at 9.5x, which we note also has a higher dividend yield at 5.7%. So, while we appreciate BHP's fundamentals and growth opportunities ahead (especially in copper), we continue to discover more value in a mining stock like Rio Tinto. Two stars from us.

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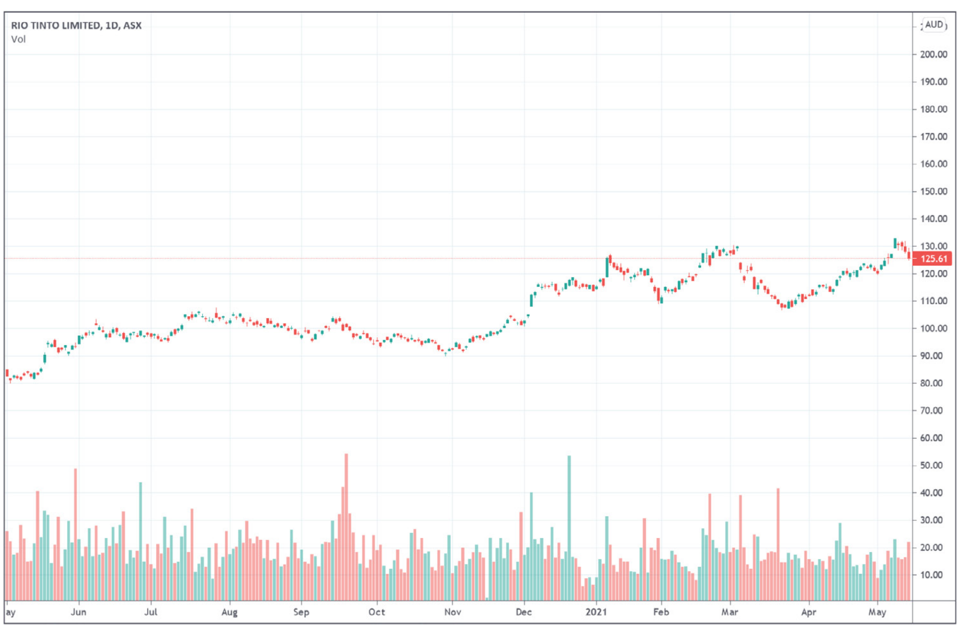

Source: Tradingview

The China influence

Rio Tinto is a diversified mining group that owns commodity assets around the world in iron ore, aluminium, copper, gold, titanium, bauxite and borates. The assets have long lives and are of the low production cost variety, both of which are valuable attributes for a mining company.

Iron ore is at the heart of the Rio Tinto business as it accounts for 60% of revenue. In the near term this is good news given the rebound in demand from China and rising iron ore prices. Iron ore is used to make steel for things like automobiles, construction and infrastructure projects. Steel production has ramped during the global economic recovery while steel inventories have stayed low. These trends have pushed iron ore prices to their highest level in years at over US$200 per tonne.

Longer-term, however, Rio Tinto’s exposure to iron ore will be a drag on its financial performance if the forecast for iron ore prices plays out as expected. Once the effect of Chinese government stimulus wears off and iron ore supply increases, iron ore miners may be in for a rude awakening. Iron ore prices are also expected to face downward pressure from China’s recent lifting of a two-year ban on scrap metal imports. The move was part of the country’s plan to reduce its carbon emissions by making more steel from recycled metals instead of iron ore. Considering that China accounts for more than half of the world’s steel production, if the policy stays in place, the effect on iron ore prices could be devastating. Consulting firm Wood Mackenzie's latest long-term forecast for iron ore is US$70 per tonne. If the forecast bears fruit, Rio Tinto's largest business will experience significant margin declines.

Aluminium prices have also rebounded sharply since we last checked in on Rio Tinto, thanks to increased demand from the transportation sector. The current aluminium spot rate of US$2,451.70 is the highest it has been since October 2018. Unfortunately, the story is similar here. A rebound in global demand has driven the price increase, but this is expected to be outweighed soon by increased global supply due to higher Chinese exports. A recent Reuters Base Metals Polls showed that the median 2022 price forecast for aluminium is US$1,950.

Oyo Tolgoi and the CEO change weigh on the stock

In FY20, Rio Tinto delivered 3% higher revenue, of $44.6bn, a 13% increase in underlying EBITDA to $23.9bn, while underlying earnings were up 20% to $12.4bn. The net debt position decreased $3.0bn to a modest $0.7bn.

The group has a disciplined capital allocation strategy that separates it from its mining peers. It has exploration programs across 17 countries and spends approximately $250m per annum on replacement and growth projects. It has also historically been one of the more shareholder-friendly ASX-listed shares through dividends and buybacks. Despite the challenging operating environment, Rio Tinto paid out 72% of its earnings as dividends last year.

One of its largest growth projects is the Oyo Tolgoi copper and gold mine. It is also one of the group's most promising assets, but has thus far been more of a headache. More than 80% of the mine's value is deep underground making it a cost-intensive endeavour. The project has suffered from several legal challenges, delays and cost increases over the years. Rio Tinto's July 2020 update on Oyo Tolgoi included a projected delay of up to 29 months for first production and a cost increase of up to $1.8bn beyond the original $5.3bn capital expenditure.

Another area of uncertainty is Rio Tinto's recent leadership change. On 17 December 2020, the group appointed Jakob Stausholm as chief executive effective 1 January 2021. Mr. Stausholm was previously the company's CFO and while he has a good financial mind and track record of strengthening the balance sheet, his potential for delivering operational success is a big unknown. The appointment of interim CFO Peter Cunningham is another layer of uncertainty, in our view.

Metal price outlook too heavy

Despite the stronger commodity pricing environment, Rio Tinto faces the potential for lower iron ore and aluminium prices over the next couple of years. The rallies in both metals are widely expected to take a turn for the worse as the supply-demand situation become less favourable. Therefore, we can see the shares getting a boost from near-term performance, but the unfavourable outlook doesn't sit well with our long-term investment style.

Rio Tinto's valuation is the most attractive it has been since 2018 based on its FY22 P/E ratio of 9.5x. However, things get more expensive as we start to look down the road to FY23 and FY24, when the commodity pricing environment is expected to weaken. The company's earnings multiples are in excess of 12x in both years. However, the dividend yield for FY22 is 7.4%, which we find quite attractive. Rio Tinto is one of the stronger mining shares to own, but based on the iron ore and aluminium price outlooks, we can't dig out more than three stars. With that said, we like it better than BHP right now.

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Share price chart

Source: Tradingview

As hospitalisations go, so too go sales

Fisher & Paykel is a very different company compared to its 1930's roots as a refrigerator and washing machine importer. Today, it makes appliances of a different sort, a range of equipment used to treat obstructive sleep apnea (OSA) and other respiratory conditions in adults and adolescents. Its products are used in both hospital and home care settings and are mostly sold outside of New Zealand in over 120 countries. The hospital side of the business traditionally accounts for more than 60% of revenue and from a geographic standpoint, North America and Europe together represent nearly 75% of sales.

The company is best known for being a leading provider of humidifiers for OSA sufferers, but the near-term catalyst has been global demand for ventilators to treat COVID-19 patients. Fisher & Paykel was immediately deemed an essential service, which meant that, even after New Zealand's Prime Minister raised Auckland's alert status to level three in August 2020, it continued to supply much-needed respirators from its Auckland facilities.

As coronavirus cases spiked in many parts of the world in late CY20, so too did demand for F&P's respirators. Partway into the pandemic, it became best practice in the global medical community to use nasal high flow therapy as a front-line COVID-19 treatment rather than later into the treatment protocol. This only added to the urgency associated with ventilator demand and led to a period of hyper-growth for Fisher & Paykel. In the nine months ended 31 December, hospital hardware sales were up a staggering 446%.

Slowdown ahead

The company's fiscal 1HY21 encompassed the six months ended 30 September 2020, so the result effectively captured the first six months of the pandemic. In this period, net profit after tax (NPAT) soared 86% to $225.5m on a 59% increase in revenue to $910.2m. Hospital products sales accounted for 75% of revenue compared to the 60% historical average as hospitals worldwide tried to get their hands on as many F&P Optiflow and Airvo systems they could. We note the bottom-line result would have been even better had Fisher & Paykel not had to pay up for expedited air freight costs.

What was also telling about the interim result was that the home care side of the business was still able to grow revenue by 5% despite many sleep clinics around the world being closed and access to personal residences limited. As these clinics reopen at full capacity, more patients will be diagnosed and sales of products, like the newly launched Evora and Vitera masks, should start to take off. Adoption of the new patient mask app that was recently introduced in Australia, the UK, the US and Canada also holds the potential for homecare growth. We see upside in the homecare business as helping to offset a slowdown in COVID-19 demand. The market is braced for a sharp slowdown in EBITDA in FY22, but we believe this area could be a source of an earnings surprise.

Fisher & Paykel is also prepared to come back down to earth. Management's forecast of $1.72bn in FY21 sales reflects an expectation that hospital equipment demand will normalise in the second half the year. Plus, freight costs, whether air or ground, are higher today than they were a year ago, so the 2HY21 result may not be as strong as it would appear to be. Even the high end of the company's FY21 NPAT guidance ($415m) assumes profits will slow more than 15% sequentially. So, with peak profit growth behind us, the market will have to start to re-evaluate Fisher & Paykel on its non-COVID growth prospects.

Favourable demographics, unfavourable valuation

Much of the attention on the company has understandably been around hospitals' COVID-19 needs, but Fisher & Paykel's pre-crisis growth prospects remain intact. As the global population ages, urbanisation trends contribute to pollution and smoking remains prevalent, demand for respiratory care devices is expected to remain elevated in the post-pandemic world. Then there is the underlying current of unawareness. Many people, especially in developing nations, don't know about the causes and dangers of respiratory illness. As a result, Fisher & Paykel still has a very large underdiagnosed and undertreated population to address.

In anticipation of there being a strong need for its products well into the post-pandemic world, Fisher & Paykel is planning to build its third manufacturing site in Mexico on its existing property in Tijuana. The project will be commissioned within the next two years and will help ensure the world has an ample supply of ventilators should another crisis arise.

Fisher & Paykel is well-positioned to benefit from fast growth in the global respiratory care market that the pandemic has accelerated. However, we would breathe easier if the valuation wasn't so high. Instead, with the EV/EBITDA for FY22 at 30x, the price will continue to be an obstruction for many investors and likely create a ceiling on where the stock goes from here, especially with EBITDA broadly expected to come down. So, until there's a better entry point, F&P gets a two-star rating from us based on its current valuation. FY21 results are slated to be announced on 27 May 2021.

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