STOCKS DOWN UNDER

7 JUNE 2021

ASX Top 200 Stocks Down Under

War is God's way of teaching Americans geography.

- Ambrose Pierce (1842 - 1914), American short story writer and journalist

SYDNEY AIRPORT HOLDINGS

Brighter skies ahead, but when?

RAMSAY HEALTH CARE

Hospitals converted to COVID-19 facilities

KIRKLAND LAKE GOLD

Stock digs deeper despite a record year

SYDNEY AIRPORT HOLDINGS

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Stocks Down Under rating: ★★★

ASX: SYD
Market cap: A$ 16BN
Dividend yield: 3.2% (0% Franked)

52-week range: A$4.99 / A$7.49
Share price: A$ 6.13

When we wrote about Sydney Airport on 23 March 2020, at the absolute bottom of the Corona Crash, the pandemic was in its early stages and the friendly skies were a nice, quiet place to be if you were a bird. A little over a year later, air traffic has gradually picked up, but the runway for returning to normal volumes remains long. Although plenty of challenges and uncertainty remain, we think the stock can continue to climb higher as lifted restrictions pave the way for pent-up leisure and business travel demand.

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RAMSAY HEALTH CARE

Hospitals converted to COVID-19 facilities

Stocks Down Under rating: ★★

ASX: RHC
Market cap: A$ 14BN
Dividend yield: 1.8% (100% Franked)

52-week range: A$58.61 / A$70.50
Share price: A$ 62.91

We last wrote about Sydney-based Ramsay Health Care on Christmas Eve 2019. The stock has since been on a wild ride aboard Santa's sleigh ascending to around $80 in February 2020 before plunging to the $50 level in March 2020. In the aftermath of the steep COVID-19-induced drop, the share has rebounded somewhat, but remains below where it traded when the 24 December journey began. We continue to see challenges ahead as Australians move away from private health insurance and insurance premium increases stay low. We see limited growth potential for Ramsay Health Care, even as pandemic pressures subside.

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Share price: A$ 55.10

When we last checked in with Canada's Kirkland Lake Gold on 30 March 2020, gold prices were recovering from their pandemic lows. Since then, gold climbed to a record high above US$2,000 an ounce in August 2020 as investors flocked to the safe haven in an uncertain economic environment. The yellow metal then retreated below US$1,700, but has turned higher in recent weeks. Kirkland Lake's fortunes are largely tied to gold pricing, so if the gold bull market continues, it's strong gold mine assets should deliver some more sparkling results.

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Share price chart

Source: Tradingview

Soft pretzels outsell flights

As the sole stakeholder in Sydney Airport, Sydney Airport Holdings controls a major artery in the global travel network providing services to nearly 100 destinations around the world. In a normal economic environment, air transportation accounts for the largest part of revenue as it did in 2019 (45%). Yet, the company also depends heavily on non-aeronautical revenue sources including retail sales, car rentals, parking and ground transportation. Only in the upside-down operating environment that was 2020, could retail sales represent the biggest part of revenue and the non-aeronautical segments combine for nearly 70% of revenue.

Regardless of the recent revenue breakdown, the numbers have been ugly as expected. From the onset of the pandemic, Sydney Airport was quick to secure additional funding and defer non-critical capital expenditures in preparation for a bumpy ride. In August 2020, it raised $2bn in fresh equity to improve its financial flexibility, reduce net debt and position it for the future. A strengthened liquidity position and balance sheet has not just helped it survive, but placed it in a favourable position to pursue growth as the economy recovers.

Domestic volumes improving

In FY20 only 11.2m passengers stepped foot in Sydney Airport, a 75% decline from FY19. This coincided with a 51% drop in revenue to $803.7m and a 62% decline in EBITDA to $508.1m. The net loss after tax came in at a woeful $107.5m and the distribution was a giant goose egg. It goes without saying that all four operating segments had sharp revenue declines, including aviation, which saw 68% lower revenue. Only essential and critical supply chain travel has been permitted.

The forgettable FY20 voyage was marked by closed international borders, followed by closed state borders and retail operations. Things started looking up by 8 December when Victoria, Queensland and Western Australia had opened their borders with NSW. Less than two weeks later, all borders to Greater Sydney were closed as global coronavirus cases quickly approached 100 million compared to 10 million in June 2020.

As at 31 December Sydney Airport had $1.1bn of available cash and $2.4bn of undrawn bank facilities. The net debt position was a staggering $7.5bn, but over $0.7bn more debt will come off the books this year as the company uses the equity raise proceeds to repay maturing bonds. The $237.5m capex was in line with guidance and deployed to projects like retail redevelopment in terminal 1, bathroom upgrades in terminal 2, jet fuel infrastructure and runway resheeting. Eventually, these investments should improve operating efficiencies, the traveller experience and enhance the group's bottom-line performance.

It's not all doom and gloom for Sydney Airport. Although international passenger volumes were non-existent from April to December 2020, domestic passenger volume improved in each month from August to December even with state borders closed during the holiday season. On the downside, domestic seat recovery rates still lag those of surrounding countries due to the state border closures. But with vaccine distribution progressing and travel restrictions slowly being loosened around the world, we are starting to see smoother air ahead. Sydney Airport's proposal to lift restrictions in line with the Government vaccine rollout targets the lifting of travel restrictions by October 2021. As international restrictions are lifted, we expect travel volumes to uplift considerably leading to more spending on seats, in-terminal shops, parking and all the joys that go with flying.

Three-year trip to normalcy

It will be a long road back to financial health for Sydney Airport, though. The International Air Transport Association (IATA) forecasts that revenue passenger kilometres, or RPKs, will only recover to 2019 levels by 2024. In the meantime, sit back, grab a drink and enjoy this three-year flight to normalcy in the airline industry.

Sydney Airport isn't forecast to return to pre-pandemic sales until 2023 at the earliest. Fortunately, the company's cost control efforts could return it to pre-pandemic profitability a bit earlier. After another dip in EBITDA in FY21, to $594m, the analyst consensus is for EBITDA of $1.04bn in FY22 and $1.3bn in FY23, i.e. EBITDA growth of 23.6% and 17.8% respectively in both years.

This translates to forward EV/EBITDA multiples of 24x and 19.4x for FY22 and FY23, respectively. We believe this is a reasonable if not inexpensive price to pay for Sydney Airport shares, but requires a leap of faith that travel conditions will continue along a positive trajectory and not suffer further setbacks.

Given the ongoing risk of COVID-19, including record cases in India and elsewhere in recent months, we are not out of the woods just yet. If planes stay grounded for longer than expected this could have a crippling effect on airline shares, including Sydney Airport. Until we see clearer signs of sustainable travel activity, we would prefer to stay in a holding pattern. Once air traffic control starts to wave us in, we'd be more inclined to upgrade our three star rating.

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Share price chart

Source: Tradingview

Hospitals pivot to COVID support

Ramsay Health Care is Australia's largest private hospital owner with more than 70 hospitals and day surgery facilities located across the country. It also operates more than 400 hospitals outside of Australia in France, the Nordic region and the UK. Combined, these international segments account for approximately 60% of revenue. Ramsay's centres provide day surgeries, complex surgeries, rehabilitation services, psychiatric care and a range of other healthcare services to self-insured patients and patients referred by government health agencies.

As you'd expect, COVID-19 has had a major impact on Ramsay's operations. It's been all hands on deck as its hospitals have moved to help governments manage the coronavirus. Its facilities have effectively become pandemic triages rather than private hospitals although urgent surgeries and other medical services are still being provided.

As the virus spread, elective surgeries were deferred so that Ramsay could provide additional capacity for COVID-19 patients. In the span of a month, the company made agreements with Victoria, Queensland, NSW, Western Australia and England's National Health Service (NHS) to make its facilities and staff available to fight the coronavirus. It performed thousands of procedures for the UK public sector enabling NHS England

to focus on COVID-19. Although Ramsay has received cost recovery for its noble deed, with most private procedures sidelined, its financial position has been heavily compromised.

With Ramsay's businesses operating far from normal, the company decided to seek additional equity funding to improve its financial flexibility. In April 2020, just as the stock was beginning to recover, it raised $1.2bn in new equity. The move strengthened the balance sheet, but diluted whiplashed Ramsay shareholders. A month later, Ramsay completed a $300m share purchase plan (SPP) to give it even greater financial flexibility and bolster the balance sheet. We like that the balance sheet has the company in a better position for growth, but don't see strong growth ahead.

Financial results understandably weak

FY20 net profit after tax (NPAT) fell 43% to $336.9m and the final dividend was withheld. Prior to the start of the pandemic, Ramsay was on track to meet its full year targets. But from March 2020 on, restrictions on elective surgeries and the shift to a COVID-19 supporting role dragged down the result. On the bright side, the company exited FY20 with a large backlog of patients awaiting surgery, which should lead to better FY21 results pending pandemic developments.

The 1HY21 result continued to reflect the operational restrictions faced worldwide as well as lower demand for non-surgical services. Although Ramsay received government payments for making its hospitals available, this was far outweighed by higher COVID-related operational costs and the limited private health care revenue. Earnings per share (EPS) decreased 21% in the interim period, including the impact of the recent capital raise. Hospital admission rates for surgical and non-surgical care began to improve into January 2021, but with COVID-19 cases now rising in many parts of the world, plenty of uncertainty remains.

While we give Ramsay's recent financials a pass given the company's role in combating the pandemic, several underlying concerns remain. Less than half of Australians carry private health insurance, a figure that has been gradually trending lower in recent years. A steady climb in private healthcare costs is causing more people to do away with private insurance. This is leading to a diminishing customer base for private hospitals, like Ramsay.

Young people are deterred by the community rating which assigns the same private health insurance premium to everyone under age 55. Until the community rating is removed, Ramsay will have a hard time generating growth without substantial participation from the younger generations who represent the next wave of health care spenders. It remains highly doubtful that the Australian Government will eliminate the community rating.

Adding capacity as private insurance demand declines

Ramsay continues to make brownfield investments in Australia at a time when private health insurance demand is sliding and premium increases are at their lowest level in 20 years. The company invested $255m in FY20 adding 222 beds, 11 surgery theatres and 85 consulting suites to its asset base. In FY21 it is scaling back brownfield investment, but still plans to spend $129m to add more beds, theatres and oncology chairs.

In the meantime, the stock has become even more expensive than when we last wrote about Ramsay Health Care. Back then it was going for 25x FY20 earnings and today it is trading at 30.6x the consensus FY21 earnings estimate. Mind you, the share price has been on a volatile, but decline path. Meanwhile, the Paul Ramsay stake has been pared ever so slightly, but at 18.8% is still the second largest shareholding and a continued overhang.

At the risk of coming off as insensitive to the operating environment Ramsay Health Care is facing, we laud their efforts as an essential workforce in the COVID-19 battle. But as investors we must keep our 'fundamental hat' on and weigh this with the risks of the share. So, while we like that Ramsay is one of the world's leading private healthcare companies and its international diversification, we find the headwinds in the Australian marketplace, ongoing pandemic uncertainty and high valuation too much to overcome. Further surgery is needed here, so we'll stick to our two-star rating.

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Share price chart

Source: Tradingview

Digging the record results

Kirkland Lake Gold is a Canadian gold miner that trades on the Toronto, New York and Australian Stock Exchanges. Its assets are located in Canada and Australia both of which are considered stable gold mining jurisdictions. In addition to owning several prominent mines throughout Ontario, Canada, it owns the Fosterville and Stawell Gold Mines in Victoria and the Cosmo Gold Mine in the Northern Territory. The high-grade, low-cost Fosterville Gold Mine, located 20km from Bendigo, is a key asset for Kirkland. It accounted for almost half of the company's revenue last year after producing over 640k ounces of gold.

The company achieved record results in FY20 in terms of production, revenue and net earnings with the fourth quarter being its strongest period of the year. Revenue increased 78% to C$2.46bn due to the combination of a 42% increase in gold sales and a 26% improvement in the average realised gold price. Adjusted net earnings were up 24% to $922.9m and Kirkland returned the vast majority of that to shareholders in the form of dividends and share repurchases.

Certainly, a favourable gold price environment drove the result, but, to be fair, the company still had to overcome COVID-19 challenges to safely and effectively deliver the production. Nine Kirkland workers tested positive for COVID-19 in FY20. Another highlight was the contribution from the Detour Gold business, which

Kirkland recently acquired. The Detour Lake Mine accounted for over 40% of free cash flow in FY20 and is expected to deliver significant production growth this year.

Kirkland Lake recently strengthened its balance sheet in a big way by selling most of its stake in Canadian gold explorer Novo Resources. The November 2020 transaction with brokers Stifel GMP and Clarus Securities added more than $45m of cash to the balance sheet. As at 31 December 2020, the cash balance was up 20% to $847.6m and there was no debt on the books. It's hard not to like a pristine balance sheet like Kirkland's.

On the heels of the record year, Kirkland management gave an upbeat outlook for 2021. However, with gold prices off their August 2020 peak, it expects gold production (1.35m ounces at the midpoint) to be slightly below that of 2020's record 1.37m ounces. On the plus side, all-in sustaining costs (AISC) are expected to be flat compared to FY20. It also provided a three-year outlook for production that projects increases in both 2022 and 2023.

Gold reaches a peak

After moving in a sideways pattern for the better part of the 2016 to 2019 period, gold prices have been unusually volatile. Gold surged to a record $2,067.15 on 7 August 2020 amid high levels of economic uncertainty associated with COVID-19. From there gold went into correction mode due to positive vaccine developments and temporary strength in the US dollar.

Since gold is an international commodity priced in US dollars, movements in the U.S. dollar have much to do with where gold prices go. As the US dollar appreciates in value, gold becomes a less appealing safe haven investment compared to the US dollar. When the US dollar falls, gold becomes more attractive. Even though gold bullion itself and gold-linked exchange traded funds (ETFs) don't offer a yield, gold investments are widely considered a hedge against weakening currencies. The US dollar has trended lower since April 2021 and that is part of the reason we've seen gold turn higher in recent weeks.

Another driver of gold pricing is inflation. Gold is also seen as a way to protect against higher prices of goods and services, i.e. inflation. Inflation erodes the value of bonds because fixed interest payments have less purchasing power in the future. So, gold is also seen as an inflation hedge because it typically moves higher over longer periods of time. And since US inflation as measured by the Consumer Price Index (CPI) is at its highest level since August 2018, rising inflation is also behind the recent uptick in gold.

Can the gold bull keep on running?

Where does gold go from here? It's anybody's guess, but most economists seem to think the golden bull has the legs to run higher. US investment bank Goldman Sachs has maintained its 2021 gold price target of US$2,300 citing not only inflation and a weak US dollar, but ongoing risks of more coronavirus spikes. We tend to agree with the assertion that gold prices will be supported by low US interest rates, the weaker US dollar, rising inflation expectations and a rebound in retail demand as the global economy strengthens.

So, what does this mean for Kirkland Lake Gold? It means that if gold pricing and production plays out as analysts expect, the company's shares are quite inexpensive. Kirkland is trading at an EV/EBITDA multiple of 6.1x for FY21 and 5.6x for FY22. We believe this is a low price to pay for a leading gold miner that is expected to deliver 8.2% EBITDA growth this year and 9% in FY22. We think it's a good time to mine Kirkland Lake Gold shares. It's four shiny stars from us.

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