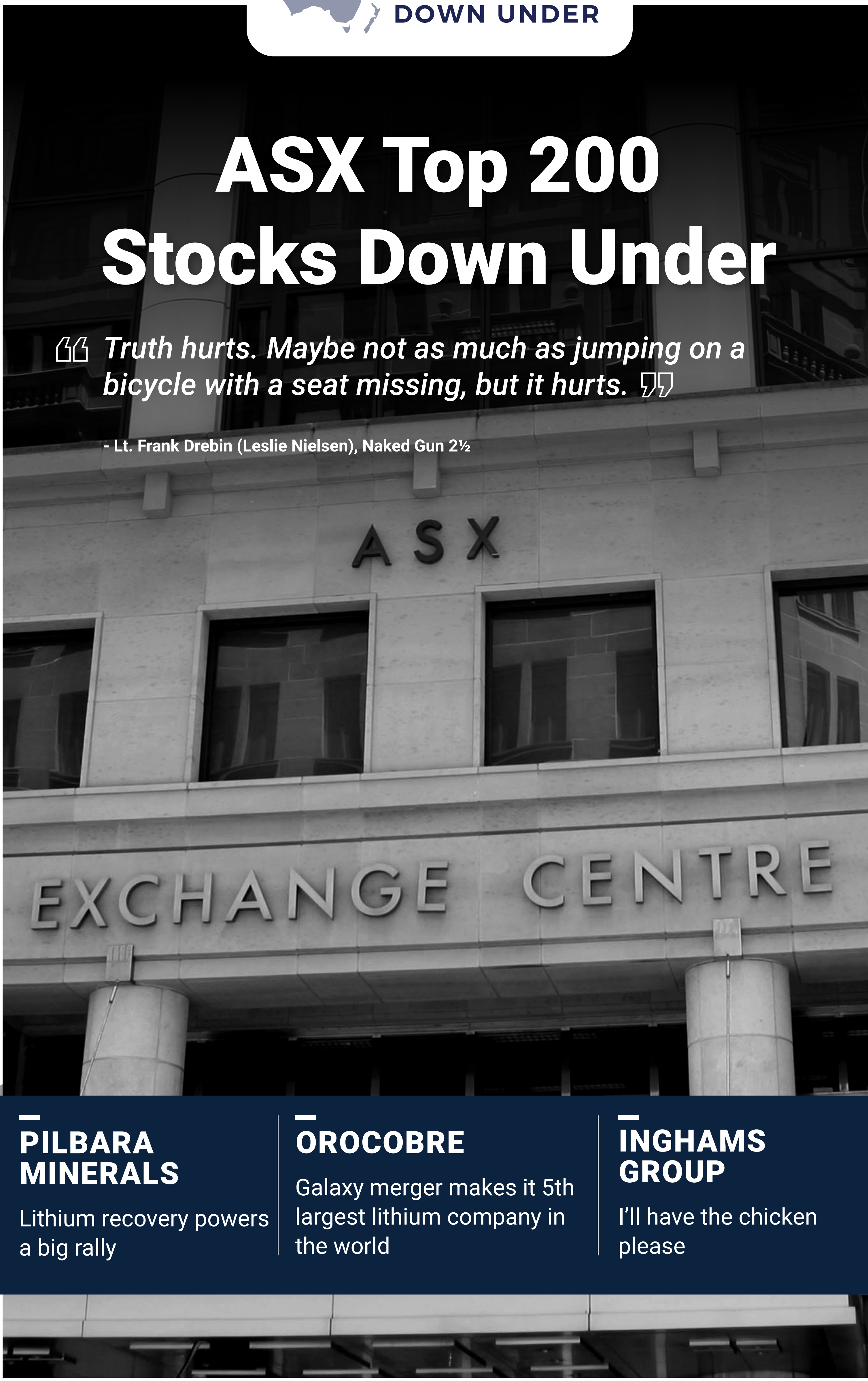
STOCKS DOWN UNDER

5 JULY 2021



ASX Top 200 Stocks Down Under

> *Truth hurts. Maybe not as much as jumping on a bicycle with a seat missing, but it hurts.*

- Lt. Frank Drebin (Leslie Nielsen), Naked Gun 2½

PILBARA MINERALS

Lithium recovery powers a big rally

OROCOBRE

Galaxy merger makes it 5th largest lithium company in the world

INGHAMS GROUP

I'll have the chicken please

PILBARA MINERALS

Lithium recovery powers a big rally

Stocks Down Under rating: ★★★★

ASX: PLS
Market cap: A$34BN

52-week range: A$0.24 / A$1.61
Share price: A$1.46

When we last wrote about Perth-based Pilbara Minerals on 7 January 2020 the share was trading at a depressed level. So was the price of lithium, the miner's key asset. What a difference a year makes. Lithium prices have since surged approximately 80% and Pilbara's share price has more than tripled. With the stock now trading near an all-time high, we think it still has plenty of room to run. Strong lithium demand from electric vehicle (EV) battery manufacturers should lead to some powerful results at Pilbara over the next few years.

READ MORE

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Galaxy merger makes it 5th largest lithium company in the world

Stocks Down Under rating: ★★★★

ASX: ORE
Market cap: A$2BN

52-week range: A$2.35 / A$7.28
Share price: A$6.62

Sometimes lightning strikes twice. Headquartered in Brisbane, lithium producer Orocobre was fortunate to have started operations in 2015 at the dawn of a lithium price boom. This lasted until early 2018. Since we last wrote about the company on 17 January 2020, Orocobre continued to ride the lithium downturn until a second boom started in late 2020. With lithium prices forecast to enjoy a prolonged upswing due to strong electric vehicle battery demand, we expect Orocobre to go along for the ride—and its stock to set new record highs.

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Dividend yield: 3.9% (100% Franked)

52-week range: A$2.83 / A$4.10
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Based in Sydney, Inghams Group has faced multiple challenges during the pandemic from lower demand to rising costs. Shares of the poultry producer haven't made much progress since we wrote about the company on 8 January 2020. Soon after the drought caused higher feed costs, COVID-19 has created a whole new set of expenses that have weighed on profitability. We think there are better times ahead for Inghams as restaurant demand improves and cost pressures ease. The low EV/EBITDA multiple has room to spread its wings and get the stock moving back toward its February 2019 beak..er, peak.

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Share price chart

Source: Tradingview

Lithium's rock-solid rebound

Pilbara Minerals fully owns the Pilgangoora lithium and tantalum mine located in the Pilbara region of Western Australia. The mine is one of the world's largest sources of spodumene, the mineral from which lithium is most often derived. Tantalum is a less abundant metal whose corrosion resistant properties make it an effective component of electronics, surgical instruments and dental implants. Together the two minerals have widespread application across several industries, which makes Pilgangoora a highly valuable asset.

It's no secret that the world is moving full speed ahead towards EV's. Countless governments have made their carbon emission targets clear, ushering in a new era of electric powered transportation. EV manufacturers and traditional automakers alike are scrambling to comply with government orders. As the companies build out their environmentally friendly fleets, there will be a massive need for the rechargeable lithium-ion batteries that power most EVs. In turn, companies like Pilbara stand to benefit from sustained demand for lithium.

Lithium is an element that gets its name from the Greek word for stone, "lithos", due to its presence in almost all rocks. While the EV market will be the primary driver of demand, high energy density lithium-ion batteries are also commonly found in portable electronic devices. The growing popularity of mobile phones, iPads and music players should therefore be a strong secondary source of lithium demand. Increasing lithium battery usage in the aerospace and defence sectors are expected to provide further support for lithium prices.

The other side of the lithium price equation is supply. Fortunately for Pilbara and other lithium miners, oversupply conditions that weighed on lithium prices in 2019 and much of 2020 have subsided. As excess supplies of the metal, including recycled lithium, have been absorbed by the market, lithium prices have been in sharp recovery mode since December 2020.

Neighbourly acquisition

On 25 March 2020, Pilbara secured a new five-year offtake agreement with Chinese lithium producer Yibin Tianyi for 75k tonnes per annum (tpa) of spodumene concentrate from Pilgangoora. The deal highlighted Pilbara's significance in the global lithium supply chain. Yibin Tianyi is a main lithium supplier to China's Contemporary Amperex Technology, the world's largest lithium-ion battery maker—and Pilbara's second largest shareholder at an 8.2% stake.

It also marked an important new revenue source at a time when global lithium demand was soft due to COVID-19. Overall, the pandemic had a minimal impact on Pilbara operations. Its mining and processing plant operations remained open although it employed a moderated production strategy.

While COVID-19 had little impact on operations, it had a significant impact on Pilbara's FY20 financial result. Although revenue nearly doubled to $84.1m, net losses increased 243% to $99.3m. The weak lithium pricing environment and weaker demand (especially from China) weighed on the bottom-line performance.

The 1HY21 result showed that market conditions were getting better. The gross margin swung from a $1.8m loss to +$8.1m and EBITDA was also back to positive territory at $1.7m. This was due to improved demand for spodumene concentrate and lower operating costs. In July 2020, the company secured a US$110m 5% debt facility to replace its existing US$100m Nordic Bond. This refinancing not only reduced its funding costs but put in a better position to capitalize on the current upswing in lithium demand.

An important development in FY21 was Pilbara's 28 October 2020 announcement of the acquisition of the Altura Lithium Operations for US$175m. This gave it access to the Altura Project, a mine that produces hard rock spodumene concentrate located immediately to the west of the Pilgangoora Project. This will allow Pilbara to effectively expand the Pilgangoora operation and leverage the lithium price recovery. It also solidifies Pilbara's position as the largest pure-play lithium company on the ASX.

Still undervalued

According to GlobalData, global demand for lithium raw materials is forecast to grow at a 25.5% rate per annum from 2020 to 2024. While there are plenty of other lithium players around the world, Pilbara should play an important role in the global lithium supply chain. Pilgangoora is one of the most coveted sources of high-quality lithium-tantalum and Pilbara's plans to further scale the project should drive efficiency gains and strong profitability for several years to come.

In terms of valuation, the EV/EBITDA is 20.4x for FY22 and 14.4x for FY23 based on consensus expectations. This is a distance from the 5x multiple the stock was going for at our last report, but still offers a lot of value given the expectation of almost 600% EBITDA-growth in FY22 and 40%-plus in FY23.

We therefore see the stock as an inexpensive way to play the lithium recovery and the longer-term growth opportunity in EVs. The EV revolution is in its early stages, so despite Pilbara's more than 500% return over the last 12 months, we believe it is still worthy of our four-star rating.

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Share price chart

Source: Tradingview

Brine is a fine way to mine

Orocobre is one of Australia's top lithium producers. It owns the Olaroz Lithium Facility located in the province of Jujuy in northern Argentina. After a seven-year development process, the first lithium carbonate was produced in 2015. Olaroz has high concentrations of lithium and potash brine and production volumes have been on the rise since the operation began. As only about 15% of the resource has been extracted, Orocobre's crown jewel has a long life ahead of it, which we find attractive as investors. Based on current production, Olaroz is estimated to have at least 40 years' worth of lithium remaining.

When it comes to obtaining lithium from the Earth, there are two techniques. The first is hard rock mining, which involves extracting lithium deposits that are found in most rocks in at least trace amounts. Then there is brine mining, which involves pumping lithium from underground saltwater reservoirs. This is considered the easier and faster of the two processes. On average, every litre of brine contains around 800mg of lithium. Once it is pumped to the surface, it gets increasingly concentrated in a series of evaporation ponds. It is then further processed at a chemical plant to produce products like lithium carbonate and lithium hydroxide.

Lithium mining by way of brine is what Orocobre does. It is less costly than hard rock mining, which is more labour intensive, meaning much of the cost is associated with paying workers. Although we are bullish on lithium producers overall, we especially favour brine producers like Orocobre because of their cost advantage.

Fifth largest lithium company in the Galaxy

Before we get into why it's a great time to be a lithium miner, let's take a step back and see where Orocobre has been. Soon after our last update, the company reached an agreement to acquire Canada-based Advantage Lithium Corp., a company it previously had a 35% stake in. Orocobre and Advantage were in a joint venture to develop the Olaroz and Cauchari basins in Argentina. In addition to taking over Cauchari and its estimated 6.3m tonnes of lithium carbonate resources, Orocobre acquired two exploration properties at Antofalla and Incahuasi. In hindsight, the timing couldn't have been better considering it added lithium resources at a time when lithium prices were slumping, but soon to recover.

Then COVID-19 hit which led to Orocobre suspending its Olaroz operations from 23 March to 9 April 2020. While the roughly two-week production halt impacted the FY20 result, what had a bigger impact was the further weakening of realised lithium prices. The onset of the pandemic ultimately prolonged a 2.5-year slide in lithium prices for another eight months. But while Orocobre had to release inventory into a weak lithium spot market, the more important trend was that costs had declined and capacity increased, setting the stage for a strong recovery. So, while FY20's headline numbers of a 47% lower average sales price and a US$67.1m loss disappointed, we were encouraged by the 22% drop in costs from Q1 to Q4.

Weak pricing continued to weigh on the 1HY21 result as revenue fell 27% and the net loss steepened to US$29.1m. But again, costs were down 19% year-over-year. A major development in 1HY21 was the 28 August 2020 announcement of an agreement with Prime Planet Energy & Solutions, a joint venture between Japanese automaker Toyota and Japanese electronics company Panasonic. Under the deal, Orocobre will supply as much as 30k tonnes per annum of lithium hydroxide and lithium carbonate through 2025 for the JV's battery production. We see this as a big deal not only in terms of the boost to sales, but the credibility Orocobre gains as a supplier to a globally recognised EV battery project.

The news only got bigger on 19 April 2021 when Orocobre agreed to merge with Applecross-based Galaxy Resources (ASX: GXY | latest report 18 February 2020) in a $4bn deal. Assuming the deal goes through, the combined company will become the fifth largest lithium chemicals company in the world. Orocobre will own 54% of the company and become a much more diversified company. Galaxy is a hard rock lithium miner of spodumene concentrate with assets in Australia, Argentina and Canada. At first glance, this would appear to increase Orocobre's cost profile, but in our view, this is overshadowed by the benefits of increased scale in a rising lithium price environment.

Powerful lithium backdrop

In the mining industry, the ideal scenario is to be a low-cost producer in a rising commodity price environment. Fortunately for Orocobre, lithium prices have been on the rise this year mostly due to its use in lithium-ion batteries for electrics vehicles. Last month lithium carbonate prices climbed to 90k yuan per tonne for the first time since August 2018. The combination of government incentives around carbon emission reductions and tight lithium carbonate supplies has been the perfect storm for lithium producers like Orocobre.

After lithium prices went from boom to bust from 2018 to late-2020, few companies invested in lithium mines. Meanwhile, demand for the metal has increased with EV manufacturers ramping production in an improving global economy. This has created a supply-demand deficit that is expected to persist in 2021 and into 2022.

Therefore, companies like Orocobre are now in the driver's seat of a massive EV battery opportunity. It is a formidable player in the battery raw materials industry given its low-cost profile and is worthy of a higher valuation in our view.

We believe the 25.3x EV/EBITDA multiple (pre-Galaxy) for FY22 has room for expansion given that EBITDA growth is forecast to go into high gear at more than 1,400% (!) that year without or without Galaxy. The year after, EBITDA is set to more than double, according to consensus estimates. Until then, brace yourself for a high-powered ride for Orocobre. It's four stars from us.

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Share price chart

Source: Tradingview

One lucky rooster

Inghams Group's roots go back more than 100 years when Walter Ingham founded the company with a single rooster and a half dozen hens on 42 acres of Liverpool, New South Wales land. Today it has more than 300 farms and facilities and is the leading poultry producer in Australia and New Zealand. It supplies chicken and turkey to grocery stores, restaurants and food service companies under the Inghams and Waitoa brands.

The poultry business accounts for more than 90% of revenue and includes the primary, free range, value-enhanced, further processed and ingredients product categories. The group also operates a feedstock business, which sells to poultry, pig, equine and dairy customers. Historically, around 85% of revenue is derived from the Australian market.

As a major player in Australia's food supply chain, Inghams has faced several challenges related to COVID-19. The company had to realign operations to comply with social distancing rules, which led to inefficiencies and higher costs. It suspended production of some value-enhanced products and had to close its plant in Thomastown, Victoria after five employees tested positive. Meanwhile, government restrictions heavily impacted demand from the hospitality and tourism industries as well as restaurants, which were limited to delivery and drive-through service. After an initial surge of pantry stocking, consumer shopping activity faded in the retail channel. Inghams has done just about everything it can to manage costs. It reduced discretionary spending, implemented a hiring freeze and deferred capital expenditures.

Improving demand across channels

Still, the impact of the pandemic on sales volumes and expenses were apparent in the FY20 result. A weak 2HY20 offset a decent 1HY20, limiting core poultry volume growth to 3.3%. This was largely due to the level 4 restrictions in New Zealand where volumes fell 2%. In addition to COVID-19 expenses, tight domestic wheat supply conditions and inflation of key ingredients weighed on costs. In the end, underlying EBITDA fell 14% to $179.7m and underlying net profit after tax (NPAT) declined 24% to $78.8m. Net debt rose above $300m due to higher inventory.

On the bright side, the 1HY21 result showed that poultry demand strengthened, and inventory levels trended lower. Core poultry volume was up 4% and trading volumes returned to pre-pandemic levels. Management noted solid demand in the quick service restaurant (QSR), retail, food service and wholesale channels, but ongoing weakness in the export business as certain overseas poultry markets remained closed. Wheat prices trended lower while soymeal futures rose significantly due to increased demand from China and political headwinds in South America. This combination bodes well for the feedstock side of the business. Underlying EBITDA increased 4.3% to $218.6m and underlying NPAT increased 28% to $28.4m on revenue growth of 4.6%. Despite the tough stretch, the balance sheet is in good shape after excess poultry inventory was reduced by an additional $42.3m in 1HY21 and leverage fell to 1.7x. Inghams has ample liquidity and access to funding if needed.

Leadership change

On 29 March 2021, Inghams announced that CEO Jim Leighton was resigning and returning to the United States for personal reasons. The abrupt departure stunned the market and the share price has yet to recover from this news. Director Andrew Reeves has since taken over the CEO role and brings good industry experience as the former CEO of Sydney-based food company George Weston Foods.

Looking ahead to the rest of this year and CY22, Inghams should benefit from a continued improvement in 'out-of-home' demand. As restrictions on international travel are lifted, tourism, hospitality and restaurant customers are likely to order a lot more chicken and turkey to keep up with pent-up travellers' appetites. QSRs should also be an important source of demand as more people zip around the country for work and pleasure. Along with the improving demand environment, management's expectations for lower feed costs in 2HY21 should help drive a much better bottom line result.

The shares are even less expensive than the last time we reviewed Inghams at 7.1X FY22 EBITDA and 6.9x FY23 EBITDA. Although EBITDA growth will likely only be around 3% to 4% in the next few years, this is a relatively cheap price to pay for a company with a dominant position in its market. The fully franked dividend and 3.9% yield are also nothing to balk at, so we give Inghams Group four stars.

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