STOCKS DOWN UNDER

19 JULY 2021

ASX Top 200 Stocks Down Under

"Even if I knew that tomorrow the world would go to pieces, I would still plant my apple tree."

- Martin Luther (1483 - 1546), German priest and professor of theology

SKYCITY ENTERTAINMENT GROUP

Without tourists, only two cherries on the reel

PIEDMONT LITHIUM

Timing is everything

ST BARBARA

A dip worth buying

SKYCITY ENTERTAINMENT GROUP

Without tourists, only two cherries on the reel

Stocks Down Under rating: ★★

ASX: SKC
Market cap: A$2BN
Dividend yield: 3.0% (0% Franked)

52-week range: A$2.14 / A$3.44
Share price: A$3.19

Much has changed since we raised the caution flag on New Zealand casino operator SkyCity Entertainment Group on 30 January 2020. At the time, the coronavirus was still confined to China, but the impact on visitors from Asia was already being felt. The global casino industry has been among the hardest hit by the pandemic and the slowest to recover. Although SkyCity's stock is up 45% over the past year, tourist traffic is still down. Absent this key source of revenue, we wouldn't be comfortable placing any bets.

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Timing is everything

Stocks Down Under rating: ★★★★

ASX: PLL
Market cap: A$1BN

52-week range: A$0.08 / A$1.14
Share price: A$0.92

We last wrote about United States lithium producer Piedmont Lithium on 30 January 2020. At the time, we projected a rebound in lithium in 2021 and the silvery-white metal has lived up to expectations. Lithium hydroxide, a key ingredient in lithium-ion batteries for electric vehicles and mobile phones, is up 91% year-to-date. We see robust demand and tight supply conditions continuing to support lithium pricing. Piedmont Lithium shares have soared nearly 800% over the last 12 months and the EV party has only just begun.

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Share price: A$1.95

The last time we wrote about Melbourne-based St. Barbara (21 January 2020) it was moving past mechanical issues and production downgrades at the Gwalia gold mine. Then COVID-19 hit and gold prices spiked above US$2,000 an ounce for the first time. St Barbara shares joined in on the gold rally but since gold's August 2020 peak, prices have trended lower. Despite gold rebounding in recent weeks, St Barbara has lagged amid declining production and rising costs. But we think the undervalued gold miner can dig out of its current slide.

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Share price chart

Source: Tradingview

SkyCity grounded

SkyCity Entertainment Group owns three casino and entertainment complexes in New Zealand and one in Adelaide (Australia). While its electronic gaming machines (EGMs) and gaming tables are the heart of the business, it also generates revenue from hotel rooms, convention facilities, restaurants, bars and parking. Its prized possession, the SkyCity Auckland Casino, sits at the base of the iconic Sky Tower that defines the Auckland skyline. In a normal operating environment, it accounts for approximately 80% of group revenue. SkyCity holds an exclusive casino licence for SkyCity Auckland through 2048.

The group's other New Zealand casino properties are in Hamilton and Queenstown. The Adelaide casino, which has a 2035 licence expiration, underwent a $330m expansion last year. The timing was unfortunate as the venue was closed or operating at limited capacity for much of 2020. The new complex started taking hotel bookings as of December 2020, but with demand limited to mostly local travellers, it's off to a slow start.

Like other tourism and leisure industry participants, SkyCity's business has been significantly impaired during COVID-19. After New Zealand's first case was confirmed on 28 February 2020, border controls, social distancing measures and mass gathering restrictions slowed operations. Fewer visitors to Auckland and reduced domestic activity dragged casino, hotel as well as food and beverage revenue lower. As domestic-focused venues, the Hamilton and Queenstown casinos were less impacted by the lack of international

business, but still felt the wrath of lockdown conditions and muted leisure spending. The story was similar at the Adelaide casino.

No more bets

All SkyCity's properties, including Adelaide, closed on 23 March 2020. The key Auckland location then reopened briefly before a spike in cases in New Zealand's largest city prompted a second closure of the casino. Adelaide and the other New Zealand properties stayed opened, but under distancing and hygiene mandates that limited SkyCity's revenue and elevated its safety costs.

Amid all the turmoil, the group completed a $180m share placement to improve its liquidity position. It also repaid its 2015 bonds early and completed a $50m share repurchase plan to strengthen the balance sheet. While these were good steps for survival, they couldn't help the lack of business that weighed on the FY20 result. Normalised revenue fell 24% to NZ$779.5m, EBITDA declined 38% to NZ$200.7m and NPAT was down 60% to NZ$66.3m. Aside from COVID-19, the results were impacted by the October 2019 fire at the neighbouring New Zealand International Convention Centre (NZICC).

SkyCity couldn't catch a break from the heavens in FY20 and this was reflected in our cautious January 2020 stance. In addition to our early COVID-19 worries, we were concerned about SkyCity's product mix, namely its dependence on EGMs. This is still an issue because SkyCity Auckland has more than 10 EGMs for every gaming table, despite the latter being the more profitable offering.

In FY20, the international business was down 60% and accounted for only 6% of revenue compared to almost 20% in FY19. So, much of SkyCity's fortunes will depend on the degree to which overseas visitors return to Auckland in the aftermath of the pandemic. We are equally uncertain to what extent large-scale conventions will be booked.

As international travel restrictions loosen up, we can see people being weary of potentially getting stuck in a foreign country if pandemic conditions were to worsen. For this reason, travellers from China and other parts of Asia may be more inclined to stay closer to home in the near term and not make New Zealand part of their travel plans. International gamblers may be more likely to opt for the Macau casino scene until they get more comfortable with travelling further distances.

A dicey leadership situation

Overall trading conditions have improved since the start of FY21, but the pressures on the tourism businesses have persisted. Although local gaming activity has picked up, the hotel and international businesses have lagged. In 1HY21, normalised revenue decreased 21% to NZ $386.9m, EBITDA was down 22% to NZ$119.9m and NPAT fell 42% to NZ$43.7. The result showed us that the road to recovery remains long.

A major management transition took place on 30 November 2020 when CEO Graeme Stephens retired and was replaced by former COO Michael Ahearne. This was followed by the resignations of CFO Rob Hamilton and Chief Marketing Officer Liza McNally in February 2021 and March 2021, respectively. We believe the recent upheaval in the management team is more reason for investors to be cautious.

Gearing is low and the balance sheet is in good shape despite the ongoing impacts of COVID-19. Unfortunately, this and the 3% dividend yield are far outweighed by the uncertainty swirling around the business.

Until SkyCity improves its product mix and overseas travel returns to pre-pandemic levels, it will be hard for the group to generate meaningful earnings growth. In the meantime, the casino operator will be playing a game of catch up with EBITDA not expected to return to its FY19 level until FY23. Therefore, we see greater opportunity in cyclical consumer stocks that will return to pre-pandemic profits sooner and have more certain paths to growth.

The share is trading at 10.4x EV/EBITDA for FY22 and 9.1x FY23. Although this valuation isn't sky high in relation to expected EBITDA growth of 21% and 15% respectively in FY22 and FY23, it doesn't make us want to roll the dice on this one just yet. Only two stars from us.

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Share price chart

Source: Tradingview

Tesla deal electrifies Piedmont shares

Piedmont Lithium, which trades on both the ASX and Nasdaq, operates a lithium project in the US state of North Carolina. The development is in the Carolina Tin Spodumene Belt (TSB), one of the world's largest sources of spodumene. Spodumene is the primary source of hard rock lithium, with brine being the other major lithium source. It is considered the main feedstock for lithium hydroxide, with more than 80% of it produced in China. After the spodumene is mined from the Carolina TSB, it will be transformed to the powdery lithium hydroxide compound that battery and EV makers have a high need for to make lithium-ion batteries.

Piedmont's US asset is a sprawling 568-acre landmass where the company is undergoing a phase two drilling program. It holds two advantages relative to Chinese lithium producers. One, its environmentally responsible production appeals to battery makers that care about sustainability. Two, the United States is the world's third-largest EV market after China and Germany. This puts Piedmont Lithium in the EV driver seat as a local source of high-quality lithium hydroxide.

When it comes to potential EV customers, it doesn't get any bigger than Tesla at the moment. That is precisely who Piedmont has been targeting and its efforts paid off on 28 September 2020. This is when the company

announced a five-year sales agreement to supply spodumene concentrate to Tesla. Tesla committed to approximately one-third of the 160k tonnes of spodumene that Piedmont plans to produce per annum. The starting point will be July 2022 to July 2023. The deal did much to validate Piedmont's domestic lithium supplier strategy and could lead to similar deals with other US automakers. Obviously, it is also the major reason why the stock has taken off.

Feasibility study results pending

In the meantime, Piedmont will likely continue to secure funding to advance its lithium project. It has been quite active on this front. In June 2020 it raised A$29m in a US public offering of its American Depository Shares (ADSs). This was followed by a similar A$70m capital raise in October 2020. Then on 24 March 2021, an additional A$159m equity round was completed. With a net cash position above A$200m, Piedmont is well-positioned to further develop the project.

We expected the Definitive Feasibility Study (DFS) to be wrapped up by now, but like many US mining projects, COVID-19 pushed back the timeline. The study finally got off the ground in December 2020 and is targeting a "mid-2021" completion. Once it is completed, an investment decision should soon follow. If Piedmont can break ground over the next few months, the timing couldn't be much better given the anticipated demand for lithium hydroxide in 2022 and beyond.

Earlier this year Piedmont was involved in an investment of a different sort. On 11 January 2021, it disclosed a strategic investment in Canada's Sayona Mining, a hard-rock lithium developer based in Quebec. It spent US$12m to acquire a 19.9% stake in Sayona Mining and a 25% stake in Sayona Quebec. Sayona Quebec has a supply agreement in place for half of its spodumene production. We think the investment gives Piedmont good exposure to one of Canada's top mining areas, provides geographic diversification and increases the company's overall lithium hydroxide production. This in turn should help it diversify its customer base after Tesla called dibs on a third of its planned production. Better yet, Sayona Quebec is seeking to acquire the brownfield assets of neighbouring lithium company North American Lithium, so Piedmont could have an exploration pipeline in the making.

Batteries are included

With the DFS nearing completion, construction potentially soon underway and a growing lithium base from the Sayona interest, Piedmont is poised to become a significant player in the EV battery supply chain. And with few investments being made in new lithium mines, the world's lithium supply should remain limited for the foreseeable future. Combine this with rising lithium-ion battery demand spurred by government carbon emission mandates, and Piedmont should have the ideal lithium price backdrop of low supply and high demand.

Valuing Piedmont shares is a challenge with the company not expected to have sales until at least FY22 and a positive EBITDA likely a couple of years away. Therefore, owning the stock requires taking a leap of faith that long-term production will be as advertised and lithium prices will continue to trend upward. We see no reason to believe that either will be untrue, so it's four stars from us.

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Share price chart

Source: Tradingview

Deep mine requires deep pockets

With mines and exploration projects located in Australia, Papua New Guinea (PNG) and Canada, St. Barbara is one of the country's largest gold miners. It operates under three divisions — Leonora in Western Australia, Simberi in Papua New Guinea and Atlantic Gold in Nova Scotia, Canada. Approximately 44% the company's revenue comes from Leonora, which includes the Gwalia underground gold mine. The Gwalia mine, the world's deepest trucking mine, dates back to the 1890's when it was managed by former U.S. President Herbert Hoover. It has an estimated 2.1m ounces of gold reserves at a grade of 6.4g per ton and is considered St. Barbara's crown jewel. Although the Atlantic Gold mine has a similar amount of reserves, the grade is only 1.1g per ton.

When COVID-19 started, St. Barbara was able to maintain its operations in Australia, Canada and PNG. Along with higher gold prices this helped the company finish FY20 on a good note as EBITDA increased 23% to $339m. However, net profit after taxes (NPAT) declined 11% to $108m as higher profits in the Atlantic Gold segment were offset by decreases at Leonora and Simberi. Atlantic Gold, St. Barbara's lowest-cost operation, had high ore production tonnages at its recently acquired Touquoy mine, which led to the profit uplift. Gwalia production came in at 171koz compared to 220koz in FY20 as the operation focused on sustainable production at lower grades. Overall production for FY20 was 382koz.

So, the FY20 results were mixed, but we were encouraged by the growth in both resources and reserves associated with the Atlantic acquisition and exploration activities at the Simberi sulphide project. St. Barbara exited FY20 with 6.0Moz of ore reserves and 11.6Moz of mineral resources.

Lower production, higher costs

FY21 has gotten off to a rough start. Although EBITDA increased 1.5% to $173.2m, 1HY21 production was 163koz. This was well off the company's full-year target pace and prompted management to say that FY21 production will come in at the low end of its 370koz to 410koz forecast. The all-in sustaining cost (AISC) of $1,605 was also off target.

Things got worse in the third quarter update. St. Barbara's AISC increased to $1,649 per ounce and the FY21 estimate was raised from $1,440 to $1,520. Even the high end of the range is well below first half figure, so some dramatic improvements are in order. Making matters worse, third-quarter production fell 8.2% from the December quarter to 82,303 ounces. The only bright spot of the report was a 5.7% higher average realised price of $2,247. Unfortunately, that was far outweighed by the lower production and the uplift in AISC projection.

The one thing St Barbara has going in its favour is higher gold prices. Since the correction from its August 2020 peak of US$2,067 per ounce, gold has found support at the US$1,700 level. It is now trading back above US$1,800 and may have a return to US$2,000 in its sights. Since gold is perceived as a safe-haven investment, it effectively competes with government bonds. As bond yields rise, gold becomes less attractive and vice versa. And since gold is quoted in US dollars, a stronger USD is usually bad news for the yellow metal. Recent inflationary pressures have pushed US Treasury yields and the USD higher and gold lower. Whether the inflation is only "transitory", as the U.S. Federal Reserve has insisted, remains to be seen. Bottom line, gold's path from here will largely be determined by inflation and monetary policy.

Gold demand is quite strong

Of course, demand is a big part of the equation too. In the first quarter of 2021, global gold demand fell 23% to 815.7 metric tons. This was driven by outflows from gold-backed exchange traded funds (ETFs). Yet interestingly, demand for gold bars and coins was up 36% as physical gold investors "bought the dip". Demand from the jewellery segment was also up to the tune of 52%. This was especially the case in China where jewellery demand more than tripled to its highest level since 2015. Gold demand was up in the technology sector as well. So, the message here is that most sources of gold demand are strong in conjunction with the global economic recovery. Only ETF investors are holding it back. Some are moving their money to equities, while others are hopping on the cryptocurrency bandwagon.

Then there's supply. Elevated gold price conditions are attracting new mining projects. This holds the potential to raise global production levels and keep a limit on how high gold can go. But as these projects are often several years in the making, it will be some time before oversupply potentially becomes an issue.

Undervalued gold play

Just as physical gold investors bought the recent gold dip, we see the downturn in St. Barbara as an opportunity to do the same. The company undoubtedly has work to do with its cost structure. This will be a challenge considering the costs involved in deep mining at Gwalia. But we see room for cost improvements and production increases looking into FY22 and beyond.

Many investors don't want to wait around for that story to unfold and that's why the stock is where it is today. However, for the patient investors among us we see value in purchasing St. Barbara here.

Any way you slice it, the shares are inexpensive, in our view. They trade at EV/EBITDA multiples of 3.6x for FY22 and 3.3x for FY23. Not bad if you're getting EBITDA growth of 28% in FY22 and 8.5% in FY23, based on consensus estimates. We believe this makes the stock one of the cheapest ways to gain exposure to gold. The 4% dividend doesn't hurt either. It's four stars from us.

Pitt Street Research Pty Ltd

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