STOCKS DOWN UNDER

9 AUGUST 2021

ASX Top 200 Stocks Down Under

> *Before you marry a person, you should first make them use a computer with slow Internet to see who they really are.*
>
> \- Will Ferrell (b. 1967), American actor

GALAXY RESOURCES

Rebounding lithium prices, Orocobre merger spark rally

NANOSONICS

This valuation needs cleaning

PACT GROUP HOLDINGS

Thinking outside the box

GALAXY RESOURCES

Rebounding lithium prices, Orocobre merger spark rally

Stocks Down Under rating: ★★★★

ASX: GXY
Market cap: A$2BN

52-week range: A$0.74 / A$4.17
Share price: A$4.84

Since we last wrote about Perth-based Galaxy Resources (18 February 2020) the share price has skyrocketed to another dimension. Up 385% over the past year, the hard rock lithium producer is rapidly closing in on its January 2018 all-time high of $4.42. Less than a year removed from trading under $1.00, the remarkable turnaround has been sparked by a sharp recovery in lithium prices—and more recently, a proposed merger with Orocobre. We expect Galaxy stock to time-travel to new heights as global electric vehicle (EV) demand soars.

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Market cap: A$2BN

52-week range: A$4.88 / A$8.25
Share price: A$5.26

Sydney-based Nanosonics is the leader in the global infection prevention industry. The last time we wrote about the company (20 February 2020) the pandemic was getting underway. To contain the spread of the coronavirus, the company's Trophon disinfection products were in high demand from healthcare facilities in China and soon thereafter the rest of the world. But after a sharp rally at the end of last year, the market has recalibrated the company's lofty valuation sending it down 32% year-to-date. It's still to pricey, in our view.

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Dividend yield: 2.1% (65% Franked)

52-week range: A$2.04 / A$4.02
Share price: A$3.89

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Share price chart

Source: Tradingview

Lithium's electrifying surge

Galaxy Resources produces lithium carbonate from hard rock deposits found in the Mt. Cattlin Mine in Western Australia. Located near the town of Ravensthorpe, the mine is a rich source of the hard rock lithium mineral known as spodumene. Lithium's most prominent use is lithium-ion battery production although it is also used to make ceramics, glass and electronics. The mine also contains deposits of tantalum, a rare metal known for its corrosion resistant properties. In addition to Mt. Cattlin, Galaxy has a high-profile lithium brine project in Argentina (Sal de Vida) and the James Bay spodumene lithium project in Canada.

Lithium producers are finally enjoying better times after three years of falling lithium prices. The commodity finally hit rock bottom late last year and has more than doubled since. Now back to where it was in mid-2018, lithium needs to double again to return to its late-2017 high, but the pace of the recovery suggests there is plenty more to come. A rise in global demand for electric vehicles (EVs) is powering the sharp rally. So too are tight supply conditions.

Where do lithium prices go from here? Many economists think they will go much higher. That's because world government leaders pushing clean energy agendas are targeting the transportation sector. Since the burning of fossil fuels for cars, trucks, airplanes, trains and ships accounts for approximately 30% of global greenhouse gas emissions, this is a logical place to start. From Australia and China to Europe and the

United States, governments and corporations are investing heavily in EVs and EV infrastructure to meet the ambitious targets.

Branching into brine

And since lithium-ion batteries power EVs, a tonne of lithium will be needed. More accurately, a lot of tonnes when you consider that building a million cars requires around 60k tonnes of lithium carbonate. Last year almost 2.5 million EVs were sold worldwide. By 2025 that figure is expected to top 12 million. While global lithium supply is expected to rise over the next four years, some have questioned if it will be enough to keep up with demand. This is potentially bad news for EV manufacturers, but good news for lithium producers.

Lithium comes from one of two places—brine or hard rock (spodumene) mines. Australia is the source of most of the world's spodumene mines while most brine production occurs in South America. Fortunately for Australian lithium producers, project lead times for hard rock lithium mines are shorter than for brine projects. This is why we've seen hard rock mine development pick up Down Under as the country prepares to be a major lithium supplier for the global EV movement.

Hard rock lithium producers are often viewed as inferior to brine producers because the cost of mining lithium is greater than pumping lithium brines from underground reservoirs. While there is a clear cost difference, we are less concerned in the case of Galaxy. Its cost structure is improving and with lithium prices climbing, the profit gap is expanding.

Plus, Galaxy is developing a new brine lithium play of its own called the Sal de Vida Project located 1,400km northwest of Buenos Aires, Argentina. The company is targeting production there to begin in late-2022, which would be great timing given the expected surge in demand and likely still favourable pricing environment. The latest projections are for annual production to be 32k tonnes per annum and for the mine to have a 44-year life. EV production will probably slow by then if we haven't moved on to personal flying vehicles, but even futurist transport modes could be powered by lithium cells.

Orocobre merger bringing out the big guns

Aside from rebounding lithium prices, the big headline out of Galaxy has been the merger with Brisbane-based lithium producer Orocobre. Now that it has been approved by the courts and shareholders, Orocobre will acquire all Galaxy shares and Galaxy shareholders would get 0.569 Orocobre shares per Galaxy share held. When it's all said and done, Galaxy shareholder will own 45.8% of the combined company. So, if you were to invest in Galaxy pre-merger, you could eventually wind up with Orocobre shares. We have a favourable opinion of Orocobre, which you may recall we wrote about last month.

The combined company will be a force to be reckoned with in the global lithium industry. It will have a high-quality, geographically diverse asset base that includes a mix of hard rock and brine lithium. It will also be in a strong financial position to allow it to scale and advance development projects.

In sharp contrast to trading conditions a year ago, Galaxy is now operating from a position of strength. With lithium prices expected to be supported by multiyear demand for EV batteries and a potential new partner by its side, the company can really put the pedal to the medal in pursuing its development plans. So, it's four stars from us.

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Share price chart

Source: Tradingview

Modern sterilisation hits the front lines

Nanosonics develops automated disinfection technology. The company's main product is Trophon, an electron paramagnetic resonance (EPR) device designed to reduce cross contamination in hospitals and other healthcare settings. Trophon is widely considered the new standard for disinfecting ultrasound probes. Traditionally, healthcare organisations have used chemical wipes to clean equipment by hand. Then there is the next-generation Trophon2 machine, which uses AcuTrace technology that supports digital record keeping and workflows for high level disinfection (HLD).

Nanosonics devices and related consumable products have been approved for sale in the United States, Canada, Australia, New Zealand, the UK, Europe, Singapore, Hong Kong, South Korea and Japan. They are sold through direct operations as well as distribution partnerships. The company has an impressive list of blue-chip customers, including GE Healthcare, Phillips, Samsung, Siemens and Canon. More than 90% of revenue comes from North America.

From an investor's perspective, the Nanosonics business model is attractive, because 60% of revenue comes from the sale of consumables and spare parts. This includes Trophon Chemical Indicators, Trophon AcuTrace Operator Cards, Sonex and NanoNebulant. Consumables along with recurring service contracts are high margin revenue sources.

High demand, limited hospital access

As you can imagine, the COVID-19 outbreak had a profound impact on Nanosonics' business. While there was elevated demand for Trophon machines, company sales reps and distributors had a difficult time gaining access to hospitals. This meant customers that had recently bought their devices faced delays in implementation. This in turn impacted Nanosonics' potential consumables and service revenue as well as opportunities to win new hospital business. But unlike some medical device providers, Nanosonics wasn't hampered by major supply chain issues and was able fulfill what orders it could.

The effects of COVID-19 were heaviest in 4Q20. In the prior three quarters, revenue was up 26%, but it increased just 1% in Q4. This led to overall revenues being up 19% in FY20. This figure would've been bigger had new units installed not been down 46% in Q4. It was, however, encouraging that consumables and service revenue climbed 36% for the year including 29% in Q4, despite the fact that fewer ultrasound procedures were performed in Q4. Unfortunately, operating expense growth (28%) outpaced revenue growth, which led to a 26% decline in profit after tax to $10.1m.

The rise in operating expenses was driven by a 37% jump in R&D investment in connection with the company's product expansion strategy. It is looking to develop new products related to instrument cleaning and disinfection, environmental decontamination, digital tracing and compliance, and storage. So, considering the cost increases were largely associated with new products that could become the next growth drivers, we are less concerned about the higher operating expense profile.

The 1HY21 result did little to stem the tide of investors starting to lose interest in Nanosonics stock. Half year revenue fell 11% to $43.1m. Key customer GE Healthcare made fewer purchases because of how COVID-19 impacted its inventory and the stronger Aussie dollar also weighed on revenues. The installed base of Nanosonics devices rose above 25,000, but this was only a 6% increase from six months prior. Operating expenses continued to head higher during the interim period, in line with the company's growth strategy, leading to a sharp 74% drop in profit after tax to $1.5m. We think the market has unfairly deemed Nanosonics a one-hit pandemic wonder, but was justified in correcting the stock's valuation after it had run to a record high above $8.00.

More downside ahead

The balance sheet has strengthened over the past 18 months. As at 31 December 2020, the cash position was $87.9m compared to $72.2m in FY19 and there is a negligible amount of debt on the books. This gives Nanosonics a solid foundation from which to pursue growth opportunities through product expansion. In our view, it could also benefit from acquiring a complimentary business that would give it access to a broader customer base and present cross-sell opportunities.

Any way you look at it, Nanosonics shares are still expensive, even after the 2021 slide. They are trading at an EV/EBITDA multiple of 64.3x for FY22 and 40x for FY23. After the spike in demand seen over the past year, it's only natural to wonder if the company's best growth period is behind it. The average annual EBITDA growth in FY20 and FY21 amounted to about 20%, i.e. through the COVID dip. For FY23, the market consensus implies EBITDA growth of 56%, which is quite attractive given the 40x EV/EBITDA multiple for that year. However, don't expect the market to start to factor that in for another 4 to 6 months.

Nanosonics' current installed base represents 21% of the global market opportunity. There is no doubt it will have considerable expansion opportunities as the world puts increased attention on infection disease prevention in the aftermath of COVID-19. An increasing number of international markets are requiring HLD products, such as Trophon/Trophon2. Eventually R&D efforts should bear fruit leading to new product launches, which are the second major growth catalyst.

So, we still like Nanosonics' growth narrative, but dislike the valuation for FY22. We give it two stars for now. However, we believe the anticipated pick up in EBITDA growth in FY23 will likely give the shares new perspective around the end of the current calendar year as the market sets it's sights on the next financial year, FY23, that will start in July 2022.

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Share price chart

Source: Tradingview

Packaging solutions for all

As the largest manufacturer of rigid plastics in Australia and New Zealand, Pact Group Holdings (PGH) provides speciality packing for a diverse set of consumer and industrial customers. Companies in the food, dairy, beverage, personal care, agricultural, chemical, infrastructure and industrial sectors all rely on PGH solutions. The company converts plastic resin and steel into rigid packaging. This means both the cost and pricing of commodities are key determinants of financial performance.

In addition to the core packaging business, PGH offers material handling and recycling and sustainability solutions. Together, Australia and New Zealand customers account for 86% of revenue. The remainder of sales are generated in Asia where the company has a growing presence after a string of acquisitions.

So, what has been the impact of COVID-19 on a packager like PGH that has its nose in many corners of the economy? Well, not surprisingly, sales slowed in conjunction with the decrease in consumer and industrial activity last year. Supply chain disruptions have also weighed on performance.

All things considered, though, PGH delivered a decent result in FY20. Revenue slipped 1% to $1.81bn, adjusted EBITDA increased 1% to $234m and net profit after tax (NPAT) was up 5% to $81m. Not explosive profit growth by any means, but factoring in the unusual economic environment in the back half of the year and the low growth nature of the packaging business, there's not much to complain about.

An ESG friendly share

An interesting development last year was the formation of a joint venture (JV) between PGH, Japanese drink maker Asahi Beverages and Melbourne-based waste management company Cleanaway Waste Management. Named Circular Plastic Australia, the trio is developing a $45m recycling facility in Albury-Wodonga, located on the state border between New South Wales and Victoria. The facility will be able to recycle about one billion polyethylene terephthalate (PET) bottles per annum. This represents a 50% increase in Australia's PET recycling capacity to 85,000 tonnes.

PET is a highly recyclable plastic that has been around since the 1940's. Next time you're holding a plastic beverage bottle, peanut butter container or household cleaner, check for the #1 code at the bottom. This tells you it's made of PET plastic, a popular choice among consumer product makers for its inexpensive, lightweight, yet strong and recyclable properties.

The new JV, in which PGH will own a 40% stake, is consistent with PGH's ambition to become a leader in sustainability. This is an attribute that has appealed to ESG investors in recent months. PGH has invested heavily in its plastic recycling business and is aiming to be the largest PET plastic recycler in the Australasian market by next year. The ultimate plan is to differentiate its products by using locally recycled materials. These are in increasing demand due to a global focus on sustainable packaging. The fresh food segment is an area of emphasis for PGH's sustainable packaging initiative. It recently reached a deal to acquire New Zealand's Flight Plastics NZ, which provides plastic trays and containers for the fresh food industry. The buyout will add more than 5,000 tonnes of recycled PET to PGH's sales inventory.

A value-packed share

The 1HY21 result did a lot to reinforce PGH's turnaround story. Although revenue was only up 1% to $894.4m, NPAT soared 44% to $49.9m. This was due to strong growth in the reuse and crate pooling businesses where margins are significantly higher. Despite earlier efforts to divest its contract manufacturing business, the division is still around. At least for now, it's a good thing it is because that division was a strong contributor to profits in the interim period as EBITDA increased 91%.

The pandemic has created some twists and turns for PGH, but to its credit it has maintained its commitment to two key goals. It wants to deliver a 15% return on invested capital (ROIC) and be in the top quartile of shareholder returns by 2025. Although plenty of work remains on the first goal (the current ROIC is approximately 7.5%), the recent recovery in the share bodes well for the second.

In the last few years, management has opted to retain cash to reduce debt and fund its strategic initiatives. It did, however, reinstate 3 cents, 65% franked dividend for 2020 and then issued a half year dividend of 5 cents. The dividend isn't quite what it was back in 2018 (11.5 cents per share), but is trending higher thanks to the improving trading conditions and financial performance. Still, the 2.1% dividend yield is nothing to sneeze at and shareholders may be in for some future dividend hikes.

PGH shares have rallied 83% over the last 12 months, but they are still inexpensive relative to industry peers. PGH is trading at EV/EBITDA multiples of 7.6x and 7.5x for FY22 and FY23, which is well below the 11.4x and 11x competitor Amcor (ASX: AMC | see 13 August 2020 report) is trading at for the same years. However, Amcor is growing its EBITDA at more than 4 times PGH's rate of just 0.7% in both years. Orora (ASX: ORA | see 5 October 2020 report), another competitor, is trading at EV/EBITDA multiples of 9.8x and 9.4x for FY22 and FY23. Similar to Amcor, it's growing its EBITDA by around 4% in both years.

So, while PGH may be the cheapest of the three, consensus estimates imply that the company is not really growing its EBITDA in FY22 and FY23. For us, that's a wrap! Two stars from us.

Pitt Street Research Pty Ltd

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