STOCKS DOWN UNDER

16 AUGUST 2021

ASX Top 200 Stocks Down Under

"If you are not yelling at your kids, you are not spending enough time with them."

- **Reese Witherspoon (b. 1976), American actress**

BREVILLE GROUP

If you can't take the heat, get out of the kitchen

BEACH ENERGY

Production is following oil prices higher

NEW HOPE CORPORATION

Clean energy push may limit coal's gains

BREVILLE GROUP

If you can't take the heat, get out of the kitchen

Stocks Down Under rating: ★★

ASX: BRG
Market cap: A$ 5BN
Dividend yield: 1% (100% Franked)

52-week range: A$23.27 / A$33.50
Share price: A$ 33.14

When we last wrote about Sydney-based Breville Group on 21 February 2020, the stock was just beginning what would be a sharp COVID-19 descent. After it plunged to nearly $10, the designer and manufacturer of small kitchen appliances rallied to a fresh all-time high above $30 as consumers spent more time cooking at home driving solid top line growth. However, it also drove Breville's valuation to new heights, which along with a declining profitability trend are reasons to stay out of the kitchen.

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ASX: BPT
Market cap: A$ 3BN
Dividend yield: 1.6% (100% Franked)

52-week range: A$1.15 / A$2.04
Share price: A$ 1.21

During our last report of 24 February 2020, the coronavirus was still an epidemic contained in China. Adelaide-based Beach Energy was about halfway through a pandemic plunge, which mercifully ended at just under $1.00 per share. Since then, the oil and gas major has benefited from a sharp recovery in the price of crude oil, which has more than tripled from the bottom. The rebound in Beach Energy stock, however, has been far less dramatic as this has yet to be reflected in its results.

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Back on 7 January 2020 we took a neutral stance on Brisbane-based New Hope. Today, the coal miner's share price is 12% below where it was nearly a year and a half ago. In the meantime, there have been some peaks and valleys for Hunter Valley and southeast Queensland mine owner. After sliding towards the $1.00 level on several occasions, New Hope has surged more than 60% over the past month. Rising coal prices are helping the company dig out from the bottom, but amid a global push towards clean energy sources, we question if the rally is sustainable.

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Share price chart

Source: Tradingview

Everything but the kitchen sink

Back in 1932, Bill O'Brien and Harry Norville threw their names in a blender to come up with the Breville name although they started with appliances of a different sort. They made radios and later sold mine detectors that were used during World War II.

Almost 90 years later, Breville Group has evolved to make a wide range of stainless-steel electrical appliances. This includes everything you could ever need in a kitchen — coffee machines, ovens, microwaves, waffle makers, indoor grills, juicers and mixers. Its products are sold in over 30 countries under the Breville, Sage, Kambrook, Polyscience and Aquaport brands. This core business accounts for 80% of sales with the remainder coming from the distribution of products made by third-party manufacturers. Customers in the Americas account for more than half of all sales.

It's hard to deny that Breville has an ability to deliver strong top line growth. However, the underlying fundamental weakness has been the company's deteriorating profitability. In FY18, FY19 and FY20, the operating margins were 13.3%, 12.8% and 11.9%, respectively. Increased price competition and the emergence of copycat generic brands have weighed on margins. Its blenders may be able to generate a lot of juice, but squeezing more out of its cost structure in a competitive kitchen appliances market is a challenge.

Shelter-in-place = dine in place

The early months of the Coronavirus outbreak had an interesting impact on Breville. While it faced its share of disruptions and supply chain challenges, it also benefitted from unprecedented pandemic demand. As people spent more time preparing meals at home, kitchen gadgets and décor became popular ways to spend money. As a result, many of Breville's appliances sold out. Even when stores where closed, customers worldwide turned to the Internet to get some shiny new kitchen toys whether they needed them or not.

Unexpectedly strong trading conditions in the March through June period drove FY20 revenue up 25% to $952.2m. Yet, the combination of US tariffs, doubtful debt provisioning and a write down of the company's Internet of Things (IOT) platform led to operating profit growth of only 3.7% and a 1.8% decrease in net profit after taxes (NPAT) to $66.2m. Breville was also hurt by an inability to meet demand due to occasional inventory shortages. Although some things were out of its control, in our view, it was a missed opportunity to turn an extraordinary demand environment into nice profits.

Despite the favourable sales environment, Breville management took the cautious road by extending its debt facilities and raising additional equity capital. This helped strengthen its liquidity position and ability to move forward with this growth agenda. The balance sheet strengthened significantly in FY20, but by 1HY21 the net cash position was trimmed from $128.5m to $90.6m. That's largely because it chose to reinvest gross profits in marketing, R&D and IT infrastructure in support of its growth plans. It remains to be seen if this translates to sustainable profit growth.

Like many consumer products companies, Breville has accelerated its digital roadmap during the pandemic. It embarked on a corporate-wide project to reposition the company as a global digital brand by streamlining its apps, content, analytics and customer support. Much of the IT work is being done in-house, including the creation of Beanz.com, Breville's all-things-coffee platform where it touts roaster partnerships and sells drip coffee and expresso machines.

Today's Hybrid Consumer wants premium or value

Interestingly, since the 1HY21 result was announced on 16 February 2021, Breville's share price has trended lower. The performance was actually much better considering this time the strong revenue growth was matched by strong operating profit growth. Sales were up 29% to $711m and EBIT rose 30% to $94.6m due to improved cost containment and reduced tariff pressures. NPAT was also up 30% to $64.2m. It's a step in the right direction, but we need to see more evidence.

Offering non-essential, high-quality appliances while competing with major brands, like Sweden's Electrolux, Germany's Bosch and America's Kitchen Aid makes it hard for Breville to be a premium brand worth paying for, at least outside of Australia. Or a value brand for that matter. It falls somewhere in between and is therefore caught in no man's land with limited pricing power. And today's Hybrid Consumers are willing to pay for premium and will go for good value too. But a brand that is neither will increasingly struggle. And without a clear path to operating efficiency gains, the share belongs on the back burner, in our view.

Share costs a lot of beans

Breville shares are trading at an EV/EBITDA multiple of 22.8x for FY22 and 20.1x for FY23. This is a lot to pay for a company with deteriorating margins in a tough consumer products industry and with EBITDA only growing by about 14% in the next few years. By comparison, the Dutch consumer electronics giant Philips is trading at less than half Breville's EV/EBITDA multiple, but is still growing EBITDA by about 11% annually. In other words, that's much better value for money.

We appreciate that Breville's dividend has been increased in each of the last five years, including during a challenging 2020. Unfortunately, the modest 1.2% yield isn't enough to offset the overcooked valuation. So, following the strong share price run in the last 18 months, we think it's time investors wake up and smell the coffee. Two stars from us.

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Share price chart

Source: Tradingview

Life's a beach

Beach Energy is Australia's largest onshore oil producer and a key natural gas supplier to the country's east coast market. It has five producing basins including the Cooper/Eromanga and Otway basins in South Australia, the Bass Basin in Victoria, the Perth Basin in Western Australia and the Taranaki Basin in New Zealand. The company also has oil and gas infrastructure assets that include the Moomba processing facility and the Otway Gas Plant. It also owns a portfolio of onshore and offshore development projects spread across Australia and New Zealand.

COVID-19 had a profound impact on Beach Energy's operations and financial results in the second half of FY20. As the crisis reached pandemic proportions, well drilling slowed to crawl amid plunging oil prices. State border restrictions complicated workforce travel as the primary focus became protecting staff and assets. Beach also faced challenges in securing components for major equipment and other global supply chain disruptions. To offset the risks, it dug up $30m in cost reductions and trimmed its FY21 CAPEX budget by 30%.

With oil and liquid natural gas (LNG) demand almost non-existent in the last few months of the year, a 17% dip in 2nd half revenue led to 14% lower FY20 revenue of $1.65bn. Underlying net profit after tax (NPAT) was down 18% to $461m, but the ROCE (return on capital employed) was still a respectable 19%. Production for the full year was up 2% to 26.7 million barrels of oil equivalent (MMboe), but the realised oil price was down 21% to $80.90.

US$100 oil?

The 1HY21 financial results still reflected a depressed oil price environment. Production of 13MMboe was identical to 1HY20, but the average realised oil price was down 38% to $64.90. Therefore, revenue fell 22% to $705m and underlying NPAT dropped 53% to $129m. On the bright side, management noted that it is on track to reach its production target of 37MMboe by FY25. If it can keep up this pace and oil prices continue to firm, the next few years could be a dramatically different day at the Beach.

In November 2020 Beach Energy's Cooper Basin portfolio expanded after it acquired Brisbane-based Senex Energy's assets for $87.5m in cash. There's a lot to like about this acquisition aside from the fact it will be earnings accretive and drive $5m in synergies per annum. First, Beach became the sole operator in the Western Flank section of its key asset where oil exploration began nearly 60 years ago. Second, it added another 0.6MMboe to its FY21 production along with 6.8MMboe in 2P (proven and profitable) reserves. It also added 10 drill-ready prospects to the exploration portfolio.

Currently, Brent crude oil prices are trading in the low US$70's. We haven't seen these levels since 2018, so well before the pandemic began. This speaks to the current strength of an oil market that may have more room to run. Optimism around strong demand for fuel as global economies reopen is fuelling the recent gains. Soon many people are expected to resume travel via plane and automobile, which are of course big gas consumers. Meanwhile, the OPEC+ group of oil-producing nations has stayed true to its plan to gradually ease supply reductions providing further support to oil.

Based on recent trading in the options market, many investors are speculating that the days of $100-plus oil will soon return. That hasn't happened since 2014 when a flood of U.S. oil output prompted a steep decline soon thereafter. If we do see triple digit oil prices by the end of next year as some think, low-cost operators, like Beach Energy, should be able to post some strong financial performances.

Deep value

The balance sheet moved from a net cash to a $46m net debt position as at 31 December 2020. But net gearing is a low 1.5% and liquidity including undrawn loan facilities is $404m. This puts it the company in a strong position to capitalise on higher oil prices through increased drilling and exploration activity.

Beach operates a high margin oil business. It has a growing 2P reserves base of 352MMboe with an increased reserves life of almost 13 years. We also like that the gas side of the business provides a steady source of revenue. Nearly all gas is sold under contract with fixed pricing or downside protection. This helps offset the fluctuations in the oil market.

Beach Energy shares are trading at 2.7x and 2.6x EV/EBITDA for FY22 and FY23. This makes it one of the least expensive ways to gain exposure to the recovery in the oil and gas markets given that EBITDA growth this financial year is expected to exceed 18%. FY23 is different with consensus EBITDA growth expectations of just 2%.

Directors also seem to think Beach shares are cheap. There has been a good amount of insider buying activity this year and hardly a sell to be found. Eight buy transactions have been placed year-to-date by seven different Directors. The biggest statement was made by the doubly named Richard Richards on May 3rd, when he bought $256k of the stock in an on-market trade.

Much like a day at the beach, we think the current valuation is very inviting, especially in a rising oil environment. We give Beach Energy four stars.

NEW HOPE CORPORATION

Clean energy push may limit coal's gains

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Share price chart

Source: Tradingview

Strong coal assets

New Hope was founded in 1952 in the Queensland city of Ipswich. It owns three coal mining assets as well as a small petroleum business through its Bridgeport Energy subsidiary. One is the New Acland open cut thermal coal mine located 28km northwest of Toowoomba in southern Queensland. The company is seeking approval to increase production at New Acland to 7.5m tonnes per annum. The legal proceedings related to the Stage 3 upsizing have dragged on, but still look hopeful after the Oakey Coal Action Alliance (OCAA) chose not to challenge the Queensland Court of Appeal's findings on related environmental issues.

The second coal asset is the Bengalla thermal coal mine, which is 4km southwest of Muswellbrook in the Hunter Valley of New South Wales. Last year the Bengalla mine accounted for roughly two-thirds of company revenue. The third is the much smaller Burton open pit mine located in the Bowen Basin of Queensland. From a geographic standpoint, the business is very well diversified. About 42% of sales are derived from Japan with the remainder from Australia, China, Taiwan, South Korea, India, Chile, Vietnam and elsewhere.

In the second half of FY20, weak global demand weighed on thermal coal prices. With fewer businesses operating during the early months of COVID-19, there was less of a need to keep the office lights on. New Hope did sell 6% more tonnes of coal during the year thanks to higher production at Bengalla, but did so into a weak market. FY20 revenue fell 17% to $1.08bn and EBITDA declined 44% to $290m.

Old energy source…

Nowadays governments worldwide are looking to reduce their carbon footprints, an agenda that directly conflicts with New Hope's business. This, along with the usual resistance from environmental groups, represents a constant headwind for the company.

Despite its high carbon and sulphur content (and therefore its contribution to greenhouse gas emissions and global warming), thermal coal is still widely used around the world to generate electricity. Thermal coal differs from coking coal, which is primarily used to make steel.

Australian coal prices have more than doubled since August 2020. In anticipation of a warmer than normal summer in the northern hemisphere, countries like Japan and South Korea have been strong sources of demand due to the expected need for air conditioning energy. Supply constraints related to mining accidents in China, disruptions in Colombia and heavy rainfall in Indonesia have also been supportive of higher coal prices.

Then there's the impact of China's ban on imported coal from Australia, which stems from the ongoing political feud. As the world's biggest coal consumer, producer and importer, China plays a key role in the thermal and coking coal markets. The move has backfired on China because coal imported from the US has become significantly more expensive than Australian coal and Chinese thermal coal prices have increased. The impact on New Hope has been less dramatic given that China accounts for around 12% of revenue. Plus, higher coal pricing is offsetting the lack of demand from China.

Since coal prices were still depressed for the better part of the interim period, the surging coal price environment didn't yet show in the 1HY21 result. The realised sales price of $78.80 per tonne was 19% below the 2020 realised price, which, along with a 23% drop in production, led to 34% lower revenue to $405.5m and a 62% decrease in EBITDA to $81.2m. Things started to look better in the second and third quarters as demand and prices rose. And the balance sheet still looks strong with a low 14% gearing ratio.

…New, but limited hope

Last year brought about a change in the leadership team at New Hope. Following the retirement of Shane Stephan on 31 August 2020, Reinhold Schmidt became the new CEO. Mr. Schmidt was formerly the CEO at Sydney coal producer Yancoal Australia. A change was also made at the CFO post where Rob Bishop took over the reins. You may recall we had a favourable opinion of the management team and still do. However, with leadership change comes uncertainty and this adds another element of risk to New Hope's risk profile.

Despite the recent run in New Hope shares, the valuation is attractive with an EV/EBITDA multiple of 3.9x for FY22, very similar to the valuation at the time of our January 2020 update. Cheap then and just as cheap now.

But speaking of "cheap, cheap", the 'canary in the coal mine' here is that the regulatory tide continues to shift against fossil fuel companies in favour of clean energy projects. Calls to move away from coal are only likely to intensify as we approach government carbon emission target dates. This could make it difficult for coal mine operators to benefit from strong demand over the long haul—and is likely to keep downward pressure on their valuations.

So, if you want exposure to coal, you'd be hard pressed to find a better company than New Hope. But with the clean energy revolution underway, the risks dim the contrarian's hopes. On top of that the market expects FY23 EBITDA to come down very substantially following a bumper FY22. So, it's only three stars from us.

Pitt Street Research Pty Ltd

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