STOCKS DOWN UNDER

13 SEPTEMBER 2021

ASX Top 200 Stocks Down Under

"There is nothing impossible to him who will try."

- Alexander the Great (356 BCE – 323 BCE), Macedonian king

TABCORP

We're not taking this bet

SIMS LIMITED

Metals recovery business shines during economic recovery

BLACKMORES

Healthy demand overseas, work needed at home and on valuation

TABCORP

We're not taking this bet

Stocks Down Under rating: ★★

ASX: TAH
Market cap: A$10.9BN
Dividend yield: 3% (100% Franked)

52-week range: A$3.24 / A$5.30
Share price: A$4.89

At the time of our 12 March 2020 Stocks Down Under report, all bets were off for Tabcorp, the Melbourne-based gaming, lotteries and wagering services operator. The impact of the coronavirus weighed heavy on the global tourism and leisure industry and sent the share to a ten-year low. The global recovery has improved the company's share price and a pending demerger stands to unlock value for shareholders. However, given the valuation and uncertainty around the split-up, we prefer to observe from the sidelines for now.

READ MORE

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ASX: SGM
Market cap: A$2.8BN
Dividend yield: 3% (50% Franked)

52-week range: A$7.50 / A$18.28
Share price: A$14.29

Since the 19 March 2020 edition of Stocks Down Under, Sydney-based metals recycler Sims Limited's share price soared from $6.42 to $15.32. The 139% advance has far outpaced that of the ASX 200 (53%) during the same period. At the time, our view was that a rebound in metal prices would push Sims higher and we reiterate that view here today. Although the so-called easy money has been made off the market bottom, higher metal prices, government infrastructure stimulus and a worldwide focus on sustainability stand to keep this global recycling leader looking shiny.

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When we last wrote about Sydney-based Blackmores on 10 March 2020, the world was facing a health crisis that even the company's most potent vitamins and supplements couldn't fix. As a result, its near-term financial results continued to suffer and the longer-term growth opportunities were pushed further down the road. We see a path to healthier performances at Blackmores as the key China market recovers and the pet business expands. But with more progress needed on the home front, we feel the current valuation is a tough pill to swallow.

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Share price chart

Source: Tradingview

Tatts not what we expected

Tabcorp is Australia's leading provider of gaming and entertainment services. Its three segments include Lotteries & Keno, Wagering & Media and Gaming Services. The Lotteries & Keno business operates lotteries and keno across the country and is Tabcorp's most compelling part of the growth narrative. Wagering & Media provides betting and retail wagering networks and runs a global racing media business. Finally, Gaming Services provides machine monitoring services. Tabcorp is the company behind a bevy of household gaming brands, including Lott, Keno, TAB, Max, PGi and Sky Racing.

A major disappointment for investors has been the integration of Tatts Group, which was acquired in 2017. Cost synergies have fallen well short of expectations and management enthusiasm around the combinations seems to have waned. The integration is now complete following the migration of UBET customers to the digital TAB platform. CEO David Attenborough had been running the show since 2011 and announced his retirement planned for this year. We think the group could benefit from a leadership change.

Mostly due to the impacts of COVID-19, FY20 revenue declined 4.8% to $5.2bn and EBITDA was down 11.5% to $995m. One bright spot was the Lotteries business, which had a significant sales increase as many Aussies looked to cure their pandemic blues with a lottery jackpot. The rest of the business was hurt by retail closures,

cancelled sports events and capacity constraints at hotels and clubs. Management also noted competitive pressures in Wagering & Media, which was cause for concern considering this is 40% of the business. Overall, the result highlighted the sharp contrast between a lotteries business that has benefitted from increased digital capabilities and a wagering business that has been slow to adapt to the digital centric market.

Betting on the wagering business

FY21 results showed signs of recovery. Revenue increased 8.8% to $5.7bn and EBITDA increased 11.3% to $1.1bn. Once again strong digital growth in the Lotteries business led the charge while venue restrictions limited earnings in the Wagering and Gaming businesses. A stronger balance sheet post-COVID has Tabcorp in a better position to grow as tourist traffic improved. Gearing based on gross debt-to-EBITDA was down to 2.8x.

In November 2020 the Australian ran a story that speculated Tabcorp may be subject to a break-up deal involving Matthew Tripp and a group of private equity investors. Management played dumb, but the rumours followed the company into the new year. In February 2021, an article again suggested it had been approached about selling the Wagering & Media business. This time around Tabcorp acknowledged various unsolicited proposals, but stopped short of saying a deal was forthcoming. The writing was on the wall.

In April 2021 Entain offered $3.5bn for the Wagering business. The following month Apollo Management matched the offer and offered $4bn if the Gaming Services business was thrown in. BetMakers then got in on the action offering $4bn for the Wagering business alone. The BetMakers proposal was later replaced with an agreement between the companies to pursue international growth opportunities. BetMakers has its sights set on the large United States market in addition to expansion in Australia.

Meanwhile, Tabcorp's recent strategic review decided it was time to break off its main Lotteries & Keno segment. The demerger will result in a new standalone company Lotteries & KenoCo while the rest of the business will be a Wagering and Gaming company under the Tabcorp name. We view this as a logical step to get the latter company ready for sale and to allow the growing lotteries business to realise its full potential. Incidentally, Mr. Attenborough has agreed to stay on until the demerger is completed.

Stretched valuation, increased risk

Tabcorp shares have more than doubled off their March 2020 bottom and are back to pre-pandemic levels. It remains to be seen how the demerger will playout and therefore the share comes with elevated execution risk.

The Tabcorp share price strength through the middle of 2021 has largely been driven by the optimism around the divesture of the Wagering & Media business and the prospects for US expansion, both of which are sources of uncertainty. Following somewhat of a consolidation in recent months, Tabcorp is currently trading at EV/EBITDA multiples of 11.8x and 10.9x for FY22 and FY23 respectively. With EBITDA expected to be flat in FY22 and up just 8.5% in FY23, we don't see a lot of upside potential for the shares. On top of that, we expect significant volatility around the share in the months ahead. So, it's two stars for us.

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Share price chart

Source: Tradingview

Zorba the Great

Sims Limited is the world's best when it comes to recovering and recycling metals and electronics to maximise value and minimise waste. Yours truly at Stocks Down Under strives for the same just with share guidance rather than metals. In the case of Sims, much of the focus is on cloud recycling, the process of recycling obsolete or broken computer equipment to help usher in the new era of cloud computing. By recycling unusable hard drives and monitors, the company plays a leading role in the manufacturing of new equipment made from 'e-waste'. Sims is also involved in buying, processing and selling other ferrous and non-ferrous recycled metals. It has operations all over the world although the United States, Turkey, China, Australia and South Korea are its major markets.

When COVID-19 hit, Sims was already reeling from a late 2019 crash in the scrap metals market, aggressive competitor pricing and low zorba prices. We note that although zorba sounds like a Greek action movie character, it refers to non-ferrous scrap metals that usually come from old vehicles or electronic equipment. COVID-19 had a severe impact on scrap metal demand from automakers and other manufacturers. Intake volumes, sales volumes and sales prices reached depressed levels in 2HY20, causing FY20 revenue to fall 26% to $4.9bn and underlying EBITDA to crash 60% to $144.9m.

Volumes started to improve in May 2020 as did ferrous and non-ferrous pricing. Much of the price recovery related to increased demand from China, which had recently classified high-grade non-ferrous metals as "renewable metal" rather than waste. With China getting a head start on the economic recovery, this was good news for Sims since about one-fourth of nonferrous scrap had historically gone to China. By July 2020, all metal divisions had returned to profitability. And starting on 1 January 2021, China began importing the newly classified renewable metals.

Alumisource acquisition bolsters US presence

The good news for Sims was that cloud recycling volumes continued to increase in FY20 despite the unfavourable economic backdrop. Management is targeting cloud growth to accelerate to 200k tonnes by FY25. The company is off to a good start. In addition to bringing on four new cloud customers in FY20, the company secured contracts with three 'significant' customers for FY21.

Over in the non-ferrous metals business, Sims is aiming to increase retail volumes from 355k tonnes in FY21 to 580k tonnes by FY25. It took a significant step towards this goal on 12 February 2021 by acquiring certain commercial and operating assets of United States aluminium processor Alumisource Corporation. The addition gives Sims an even greater presence in the North American market where Alumisource also provides furnace ready product.

Sims's financial results have looked much better in FY21 due to higher metal prices that are being driven by increased industrial demand and limited supply conditions. In FY21, intake volumes improved 4.9% from FY20, but remained at approximately 90% of FY19 levels because of the lingering effects of COVID-19. Sales were up 20.5% to $5.9bn during FY21 and underlying EBITDA more than trippled to $579.9m. This shows that cost restructuring initiatives have been highly effective and that they will further strengthen results as volumes and revenue continue to recover.

Strong balance sheet

Management was quick to respond to the COVID-19 crisis. It reduced CAPEX and restructured the business to get to a lower fixed operating cost base. Now that operating results have drastically improved during FY21, management felt comfortable enough to increase CAPEX again.

Despite its impressive return to 2018 share price levels, we believe Sims is still trading at an attractive valuation. The EV/EBITDA is 4.5x for FY22 and the P/E ratio based on FY22 consensus estimates is around 7.6x.

After a year of historic market disruption, Sims is off to a strong start in FY21. With metal volumes and prices on the rise and a disciplined cost structure in place, management has the company well positioned for growth. We also expect government spending on infrastructure to be supportive of metal prices in the medium term. We recycle our previous four-star rating.

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Share price chart

Source: Tradingview

Immunity products shine during COVID

Blackmores is Australia's leading vitamin, minerals and herbal supplements maker and a key supplier to 16 other Asia-Pacific markets. It also holds the top market share in Malaysia, Singapore and Thailand. The company sells its products under the Blackmores natural health brand as well as BioCeuticals for the physician market, and the Impromy weight management program. Then there is the animal health side of the business cleverly dubbed Pure Animal Wellbeing, or PAW, which is becoming an increasingly important part of the growth story.

In early 2000, the company was already dealing with rising materials and packaging costs associated with its manufacturing transition. Then COVID-19 came along and created further adversity. Several markets faced soft demand conditions, including Australia and China, which together account for the majority of revenue. There were also sales and supply chain challenges in China and South Korea where Blackmores has an extensive presence.

FY21 revenue was up 1.3% to $5575.9m. Fortunately, increased demand for BioCeuticals immunity products helped cushion the impact of restricted business activity in the final months of the period. Underlying NPAT

plunged 65% during FY20, leading to an oversized percentage-point increase of 61.2% during FY21 to $25.4m as the situation normalised.

China investment boosting results

Prior to COVID-19, China accounted for 20% of Blackmores overall revenue. But with China's rising middle class being a key growth catalyst it moved forward with a plan to invest more in China as well as Indonesia. The company completed a $92m equity raise in May 2020 to accelerate growth in Asia and to strengthen the balance sheet during the pandemic. Retail investors bought another $49m worth of Blackmores shares to add a total of $141m of capital to the balance sheet. Much of the investment dollars are expected to be put towards enhancing Blackmores' presence on China's digital platforms such as Tmall and JD.com.

Aside from opportunities in China, we view the pet market as another major growth catalyst. Blackmore's PAW is the leading pet supplements brand in Australia and the company is moving to expand the business in international markets to capitalise on people's increasing love for pet companionship in the COVID-19 era. In a September 2020 survey PAW posted a respectable 82% brand awareness score.

Management took another step to strengthen its financial position in October 2020 by divesting the global therapeutics business. It sold the maker of the ailing Fusion Health and Oriental Botanicals brands to Australian health and beauty products supplier McPherson's Limited for $27m. We think this move also helped sharpen the company's focus on its more compelling growth opportunities — international expansion and the global pet market.

As pandemic conditions improve, we expect Blackmores' human business to benefit from the global consumer's increased interest in leading a healthy lifestyle. We started to see signs of this in the 1HY21 results. Growth indeed accelerated as planned in several key Asian markets helping revenue increase 4% to $302.6m. China sales jumped 27% and the rest of the international business had a 19% increase in revenue. Underlying NPAT was up 8% to $19.4m giving the company the confidence to bring back its dividend payment.

Still, much more work remains for Blackmores to revitalise the Australia and New Zealand markets, which saw sales fall 15% in FY20 and a further 14% in FY21. These declines were due to a continuation of declining foot traffic and a weaker than pre-COVID-19 cold and flu season.

Still an execution story

Blackmores' stock reached the $200 mark in December 2015 when Chinese consumers accounted for nearly 40% of sales. The share price has since fallen, but had a nice run in recent months. Blackmores is now trading at 19.1x FY22 EV/EBITDA and 14.9x for FY23. While these multiples may seem high, market consensus numbers put Blackmores' annual EBITDA growth between 26% and 29% between now and the end of FY24, which we think is pretty attractive.

We note that executive director Marcus Blackmore owns 22.5% of the outstanding shares, so his activity stands to have a major influence on the stock. He has stood pat of late, unlike Chairwoman Anne Templeman-Jones who purchased 652 shares on 10 June 2021. The on-market trade was a noteworthy show of confidence, which have been few and far between among Blackmores' leadership.

Blackmores has the markings of a winner, including a strong brand, a loyal customer base and solid growth prospects at home and abroad. It's four stars from us.

Pitt Street Research Pty Ltd

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Pitt Street Research Pty Ltd provides issuer-sponsored research for Small & Mid Cap companies and is founded on more than 40 years of combined experience researching companies in a range of different sectors.

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