STOCKS DOWN UNDER

18 OCTOBER 2021

ASX Top 200 Stocks Down Under

“Today I will live in the moment, unless it’s unpleasant in which case I will eat a cookie!”

- Cookie Monster

AURIZON
Pure dividends

ALUMINA
We have a runner!

THE STAR ENTERTAINMENT GROUP
Don’t place your bet just yet

AURIZON

Pure dividends

Stocks Down Under rating: ★★★

ASX: AZJ
Market cap: A$7.2BN
Dividend yield: 7.3% (70% Franked)

52-week range: A$3.44 / A$4.44
Share price: A$3.93

Headquartered 1.6km away from Brisbane's CBD, Aurizon is a company continuing freight trains' long history of providing investors with significant yield opportunities. We last wrote about Aurizon on 30 March 2020, when the stock was $4.41 per share. We believed the market would be attractive to investors despite the rough market conditions at the time. Unfortunately, we were wrong and the stock has continued to fall. So, where did we go wrong? Well, we believe we underestimated the market's reaction to Aurizon's coal related holdings.

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Stocks Down Under rating: ★★★★

ASX: AWC
Market cap: A$6.6BN
Dividend yield: 3.7% (100% Franked)

52-week range: A$1.40 / A$2.33
Share price: A$2.27

We last reported on Melbourne-based Alumina on 24 March 2020 when the stock was trading at $1.45 per share. We rated the stock two stars and it spent most of 2020 fluctuating between $1.36 and $1.80 before jumping at the end of the year, resulting in a finish at $1.89 per share. Alumina's stock is currently going for its pre-COVID-19 highs of around $2.30 per share. Alumina spent most of 2HY20 and FY21 volatile, but flat overall. But that all changed in August after the company released its 1HY21 results, which was fuelled by the skyrocketing price of aluminium. Despite the recent surge, we think there is plenty of fuel left in Alumina's tank.

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Share price chart

Source: Tradingview

Combining then and now

When we last wrote about Aurizon, the market was in the midst of what is now commonly referred to as the COVID-19 crash. Aurizon is Australia's largest rail freight operator, transporting over 250m tonnes of domestic commodities annually. The company has assets and lines all across Australia, broken down into three categories: network, coal and bulk. Network and coal focus on the same commodity, i.e. coal. However, Aurizon categorises network as specifically its Central Queensland Coal Network. This 2,670 km network connects Newlands, Goonyella, Blackwater and Moura with the Gonnyella Abbot Point Expansion connection. In other words, the Central Queensland Coal Network connects over 50 coal mines in the Bowen Basin to five major ports, as well as some domestic consumers. Like many vital infrastructure projects, the line is not owned by Aurizon, but operated through a 99-year lease with the State of Queensland.

The main difference between the coal division and the network division, is that the coal division operates through its fleet of over 400 coal-hauling locomotives and 8,500 coal wagons, instead of owning track. Unsurprisingly, due to the prevalence of export ports and coal mines, the vast majority of Aurizon's coal operations take place between New South Wales and Queensland, constituting over 98% of its 1,800 strong workforce.

On an annual basis, the coal division transports approximately 200m tonnes of metallurgical and thermal coal, or around 55% of Australia's total export tonnage. Only around 10% of the coal the division hauls is for domestic use, specifically related to energy generation. The newspapers have it spot on, Australia's coal game is truly an export one.

Don't they haul anything else?

For those thinking the mining boom might bring some joy to Aurizon's long-suffering shareholders, you are unfortunately mistaken. We mentioned above that the company transports approximately 250m tonnes of domestic commodities annually and that 200m of that was metallurgical and thermal coal. The remainder is provided by the bulk division, which transports commodities, such as iron ore, cement, fertiliser and livestock … you name it they transport it.

However, it is important to note that this division accounts for a very small portion of the company's annual haul, only around 50m tonnes annually between it all. Unfortunately, management offered no hard pathway expanding this division to diversify the company away from coal. We would look upon such a transition extremely favourably because even though we are bullish on the price of coal in the short and medium term, we expect a global acceleration away from coal over the next few years. Due to the fact that Aurizon just transports coal, but doesn't mine it, we don't expect the current energy crunch to have much of an impact on operations.

The trouble with relying on bulk coal

FY21's results were effectively flat with revenue up 1% to $1.5bn and EBITDA down 1% to $903m. This is far from surprising when we look at Australia's coal export statistics over FY21. According to the Australian Department of Industry, Science, Energy and Resources, total coal exports declined 7.2% year-over-year during FY21 to 363m tonnes. Unsurprisingly, this was the continuation of a trend that saw volumes in FY20 decreasing 1% compared to FY19. With 80% of Aurizon's annual transported tonnage likely to remain coal, we don't see many ways for the company to improve upon its FY21 result in FY22 and FY23. While coal miners will certainly benefit from a boost in prices, we don't expect Aurizon to see much, if any, flow-on effects from the current energy crunch.

The market seems to agree with our estimation of Aurizon's future earnings potential with the median estimate from 11 analysts seeing the company's EBITDA decline of 1.2% during FY22, increasing 1.1% during FY23 and then declining 3.2% during FY23. The median revenue estimates look approximately the same.

This is not a matter of margin crunch, the market just expects a gradual operating decline over the next few years and we agree (unless management attempts to diversify away from coal). As if to drive the point home further, even the highest estimate does not paint an exciting picture. The highest of the 11 analyst estimates expects EBITDA growth of 0.6% during FY21, 2.2% during FY22 and 3.8% during FY23. While we believe this is highly optimistic, especially FY23's estimate, it shows that even in a best-case scenario, everybody agrees Aurizon's earnings are going nowhere fast. Looking at FY22, FY23 and FY24, EV/EBITDA ratios of 7.5x, 7.4x and 7.7x, respectively, paint a picture of an overvalued and stagnant company.

However, this is where things get slightly more complicated. Yes, Aurizon is going nowhere fast and will likely see a slight earnings decline over the next three years, but it will still be generating a strong profit that is more than enough to pay its dividend. With a current indicative yield of 7.4% (70% franked), even with the likely rise in interest rates, that is an attractive yield. In fact, it would not surprise us if the dividend payout increased during FY22 in order to keep investors interested in the stock.

However, as with all stocks, you still have to account for potential share price declines and with the stock currently moving towards the upper end of its 2021 trading range again, we advise caution. Therefore, based solely on the yield, we are issuing a three-star rating. There may be a better time to get into this stock.

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Share price chart

Source: Tradingview

At least it's no Alphabet

If you want a lesson in complicated corporate structures, NASDAQ-listed Alphabet is the perfect case study with a plethora of divisions and sub-divisions, including world-famous Google. While Alumina is certainly no Alphabet, its corporate structure is far from straightforward. See, Alumina is not your classic aluminium and bauxite (the main feedstock of aluminium) play and would be better described as an investment vehicle. In fact, we would argue Alumina has more in common with a Real Estate Investment Fund (REIT) than it does with a company like NYSE-listed global aluminium giant Alcoa. And that's no small statement as Alumina's sole asset is a 40% stake in AWAC, a joint venture between Alcoa and Alumina that produces approximately 10% of the world's annual alumina (aluminium feedstock).

The joint venture also has major ownership interests in six bauxite mines across Brazil (two), Australia (two), Guinea (one) and Saudi Arabia (one), 100% ownership of a shipping company and significant interests in three aluminium refineries (Brazil, Saudi Arabia and the Australia).

The joint venture is known as Alcoa World Alumina and Chemicals (AWAC) with more than 5,000 employees worldwide. Alumina only directly employs a small management team.

Back to business, but still far from usual

After crashing hard at the beginning of 2020, the price of aluminium has been on a tear with no sign of slowing down. The last time the price of aluminium broke US$3,000 per tonne was in July 2008 and while the price crashed hard shortly after, due to the Global Financial Crisis (GFC), at Stocks Down Under we believe the rally has strong fundamentals that will cause it to last at least through FY22 and into FY23. Our thesis is based on two main factors; the world energy transition and the manufacturing and infrastructure-focused recovery policies of most developed nations.

An example of future demand is Electric Vehicles (EV's). Each EV contains around 250 kg of aluminium, according to the Australian government's estimates. The Australian government also estimates that worldwide aluminium production will continue to lag behind consumption by 2,259kt during 2021, 3,746kt during 2022 and 5,075kt during 2023.

This is fantastic news for AWAC as the joint venture has issued full year FY21 (calendar year) guidance of 156,000 tonnes of aluminium and 12.8m tonnes of alumina, goals we believe are attainable. This would be a strong showing for AWAC, that produced 12.6m tonnes of alumina in 2019 and 12.2m tonnes in 2018, although it would still not see a return to 2019 and 2018's aluminium production of 161,000 and 164,000, respectively.

As you can tell, AWAC is going all in on alumina. On 1 October 2021. AWAC announced it had executed a binding term sheet with Western Australian FYI Resources (ASX: FYI | see 15 April 2021 report) to form a partnership (65% AWAC-owned) to eventually develop an 8,000mt per year High Purity Alumina (HPA) plant. The partnership is part of a long-term trial where, in December 2020, Alcoa was able to consistently produce HPA at rates greater than 99.99% Al2O3 (alumina). The partnership plans on total costs of approximately US$200m and finished around 2024.

A bright and light future

Current market estimates have FY21's full year EBITDA at $279.6m, a 15.2% increase year-over-year. However, things get really exciting when we look at 2022, when EBITDA is expected to sharply increase to $516m. This expected sharp jump in EBITDA is reliant on the price of aluminium continuing to rise over the next year and AWAC's trend of increasing alumina production and returning aluminium production to pre-COVID-19 levels.

We believe both of these assumptions are quite realistic looking at current market conditions. The stock is also currently providing shareholders with an indicative annual dividend yield of 3.8%. However, we believe this may proof to be an underestimation as management has made it clear that Alumina's profits will be returned in the form of dividends. Therefore, FY22's yield will likely be as much as double its current.

These expectations are why we believe the market undervalues Alumina with FY21 and FY22's EV/EBITDA ratios of 23.3x and 12.6x. Four stars from us.

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Source: Tradingview

Reopening offers opportunities

The Star Entertainment Group has operations in New South Wales and Queensland. Its NSW operations are based around a 20-year-old Sydney landmark, The Star Sydney. For those not familiar with The Star, it contains the only hotel in NSW to achieve a Forbes 5-Star rating, event centre, a wide range of different bars and restaurants, dance clubs, The Sydney Lyric (where Hamilton is performing) and of course The Star Casino. Unsurprisingly, The Star has suffered as NSW has gone in and out of lockdowns, suffered from restrictions and being closed to most outside visitors. This is perfectly summed up by VIP gross revenue declining 96% year-over-year to $12m, while domestic only declined 10% to $813m.

Star also owns The Star Gold Coast, you guessed it, based on Queensland's Gold Coast. This facility is in the midst of a large expansion, with a $400m second tower expected to be completed in 2024. The Star Gold Coast saw a decline in revenue of 28% year-over-year to $382m, but this was completely due to VIP revenue declining 100%. Domestic revenue actually increased 26% year-over-year as Queensland has not dealt with as many restrictions and lockdowns compared to NSW. This result does include the Gold Coast regional convention centre, though.

The second casino operation in Queensland is Star's Treasury Brisbane, a 26-year-old Brisbane landmark. In fact, Treasury Brisbane is Brisbane's only 24-hour casino featuring dinning, entertainment and bars. While VIP revenue declined 96% year-over-year, domestic revenue stole the show, increasing 38%, allowing total revenue to increase 34% to $348m.

Is this another Crown?

Here at Stocks Down Under we are quite a fan of Hanlon's razor, which states 'never ascribe to malice, that which can be explained by stupidity; don't ascribe to malice what can be plainly explained by incompetence.' This is a saying that we have applied to the Star Entertainment Group's main competitor, Crown Resorts (ASX: CWN | see 19 October 2020 report) and it seems we might have to do the same to the Star.

Unfortunately, the Star has now been accused of many of the same things that Crown was and there is certainly strong evidence so far presented by the Nine Entertainment (ASX: NEC | see 28 April 2020 report) team. On 14 September 2021, management announced that it will be subject to a review of its licence. This is a regular process, although the last one was done in 2016. The same person who ran NSW's Crown investigation will be running the Star's, so we can be confident that he will be nothing if not thorough.

While we believe it is likely that the Star is guilty of much of what it has been accused of, a Royal Commission and an external investigator have so far been ruled out and it has been stated that this investigation will be run a lot less theatrical way than Crown's was.

Another major difference is that Crown had a major shareholder that could easily be vilified, while Star does not. We believe this will help reduce the media hits on Star versus what Crown was subject to. All-in-all the risks facing the Star are large and still mostly unknown, but we believe are likely considerably less than those facing the Crown.

Directors agree, the stock is undervalued

There has been a series of director purchases of Star's stock recently, three to be precise. On 23 August 2021, Richard Sheppard purchased 50,000 shares at $3.61 per share. This $180,500 purchase increased his holdings by a sizable 20%. The next day, on 24 August 2021, John O'Neill and Benjamin Heap also increased their shareholdings, although they paid a higher price. O'Neill paid $3.75 for his purchase of 16,200 shares, while Heap paid $3.76 for his 10,000 additional shares. These purchases increased O'Neill's holding by 12.1% and Heap's by 25%. There definitely seems to be interest among directors in opening themselves up to greater exposure to Star's performance.

If you were to exclude the current regulatory risk, Star's stock is trading below fair value. The market is currently expecting FY22 to see a decline in EBITDA due to the extended lockdowns that have only recently been lifted. Therefore, we believe comparing FY23's expected growth with FY21's EBITDA offers a more realistic growth rate to base our valuation off. The market currently expects that FY23 will experience 24.5% growth compared to FY21, with the company valued at 8.4x FY23 EV/EBITDA.

However, we can't just ignore the regulatory risk and if the Crown saga has shown us anything, it's that these sorts of risks can be significant. Just look at the Star's stock price following the recent media reports.

Although we believe the casino will benefit strongly from the reopening of Australia, especially with the company's main casino being based in Sydney, we think we should remain cautious with regards to the investigation. Despite what appears to be a very high discount, the stock remains only a three-star stock for 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.