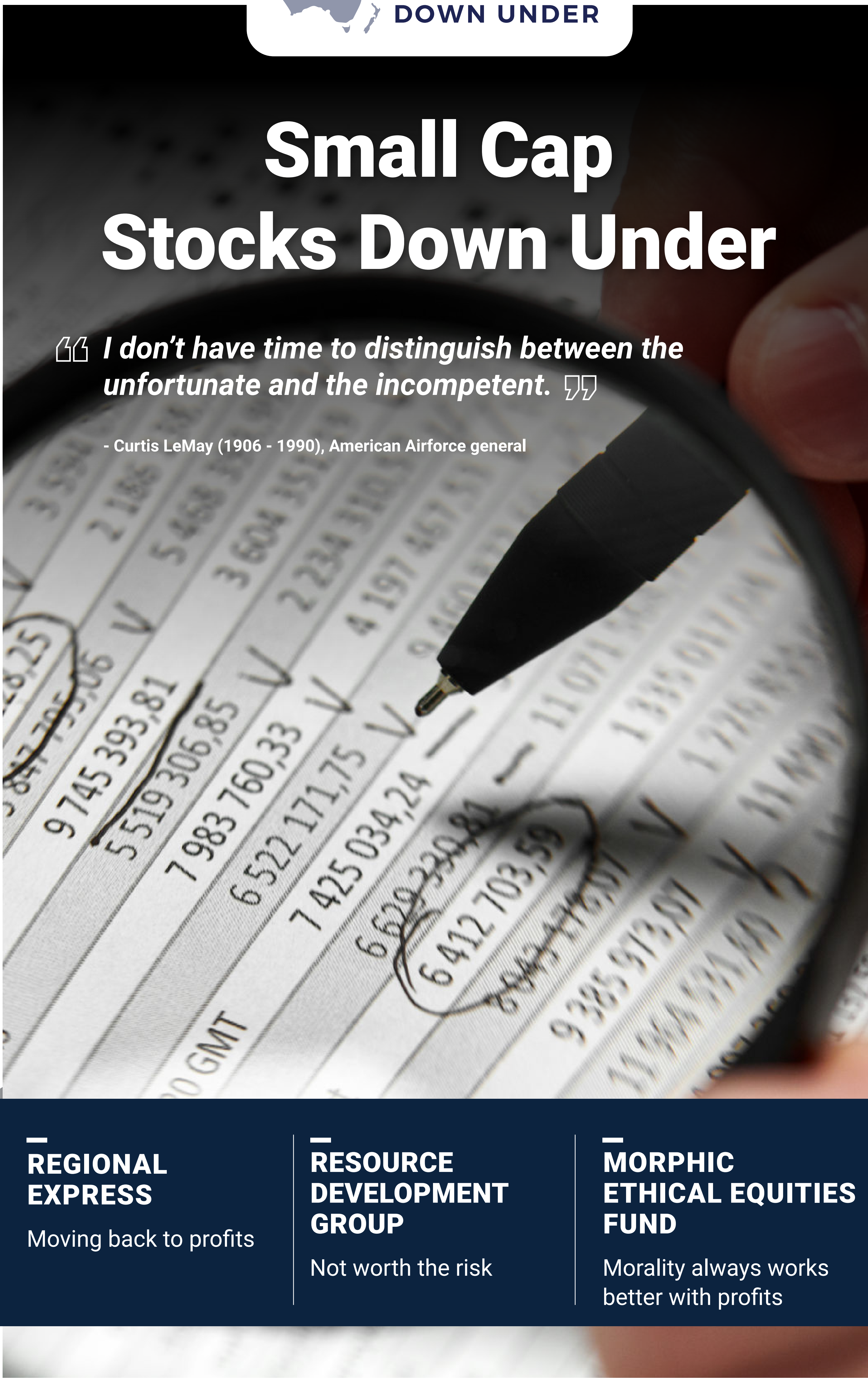
STOCKS
DOWN UNDER

22 OCTOBER 2021



Small Cap Stocks Down Under

"I don't have time to distinguish between the unfortunate and the incompetent."

- Curtis LeMay (1906 - 1990), American Airforce general

REGIONAL EXPRESS

Moving back to profits

RESOURCE DEVELOPMENT GROUP

Not worth the risk

MORPHIC ETHICAL EQUITIES FUND

Morality always works better with profits

REGIONAL EXPRESS

Moving back to profits

Stocks Down Under rating: ★★★★

ASX: REX
Market cap: A$181M

52-week range: A$1.12 / A$2.50
Share price: A$1.60

Headquartered in Mascot, New South Wales, Regional Express provides air transport services for passengers throughout Australia. The stock has struggled a lot since the December 2020 high. But now that Australia is reopening to domestic tourism and international travel again, it's time to take a fresh look at Regional Express.

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Market cap: A$135M

52-week range: A$0.035 / A$0.061
Share price: A$0.049

As regular readers of Stocks Down Under will know, we are quite bullish on the Australian mining sector (excluding iron ore) as demand for resources has skyrocketed past supply, causing a stream of new mines to be opened. In the Osborne Park suburb of Perth, the Resource Development Group has historically operated as a diversified mining services provider. However, management has determined the time is right to take its workforce expertise and look for additional opportunities, including running its own wholly-owned mines. The company certainly has the skills, but let's take a closer look at the strategy.

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ASX: MEC
Market cap: A$70.3M
Dividend yield: 3% (100% Franked)

52-week range: A$1.00 / A$1.38
Share price: A$1.325

Headquartered in Sydney, the Morphic Ethical Equities Fund was founded in 2012 and invests exactly as its name suggests, only in 'ethical' investments. Since the low-point of the COVID-19 crash at the end of March last year, this strategy has clearly worked as the stock has risen a staggering 89.3%. Combine this with $0.05 in total dividends since March 2020 and your total return moves to 96.4%, not bad for a year and a half's work. And yet, looking at Morphic's NTA as of 15 October 2021 shows that this fund is trading at a discount. So, is ethical investments a fad, or is it here to stay?

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Share price chart

Source: Tradingview

Emerging from the ashes

Fire and ashes of any kind are not the image you want in your head when you think about an airline, but when it comes to Regional Express this imagery seems to be highly apt. The company arose from the ashes of the collapse of the Ansett Group when two of its regional airlines, Hazelton and Kendell Airlines, were rescued in August 2002. When the COVID-19 pandemic decimated the global airline industry, Regional Express was already the largest regional airline in Australia with over 60 destinations. The company has fought back against the pandemic and even opened a new service in the golden triangle of Sydney-Melbourne-Brisbane. And now with interstate and international travel back on the table, the expansion seems primed to pay dividends.

On 18 October 2021, management announced that it would be resuming domestic services between Sydney, Melbourne and Canberra on 15 November 2021. The company expects to ramp up to its full flight offerings shortly thereafter. However, Regional Express does not exist in a vacuum and its expansion into the Golden Triangle puts it face to face with the Australian airline giant, Qantas (ASX: QAN | see 14 April 2020 report). In the face of this giant and the new and (maybe) improved Virgin Australia, what does Regional Express have to offer investors?

Don’t forget charters!

Regional Express generated revenues (excluding government subsidies) of $168.7m during FY21, a decline of 14.6% year-over-year. However, the decline was squarely from passenger revenue and freight. Importantly, charter revenue remained relatively stable. During FY21, passenger revenue declined 41.3% to $125.2m while freight declined only 16% to $1.1m and charter revenue actually increased 4.1% to $30.9m. Due to Regional Express’ heavy historical presence in regional Australia, it should come as no surprise that charter flights saw increased revenue during the period. During COVID-19 there has been a trend of companies and individuals chartering flights instead of risking flying commercial. However, we don’t expect charter flight revenue to plumet in the post-COVID-19 era as this was not an uncommon form of transportation pre-COVID-19 in regional Australia.

How strongly passenger revenue will recover for Regional Express during 2HY22 is a tough question for one main reason: the company has been expanding during COVID-19. As we already mentioned, management has undertaken the strategic step of breaking into the ‘golden triangle’ while the other airlines’ pants were down. Therefore, while we expect the situation to quickly move back to FY19’s level, it is unclear just how well the expansion will play out for Regional Express. However, based on management’s track record, we believe it is a question of how well, rather than how poorly.

Massive dilution seems likely

In what is already old news, on 19 November 2020 Regional Express signed an agreement with PAG Regulus Holdings for an investment of up to $150m to be used exclusively for the launch of the company’s domestic jet operations, expected to begin 1 March 2021. The service began as scheduled and was a big win for Regional Express at a difficult time for the airline industry. However, in order to secure this funding, the company had to issue a lot of convertible notes. If and when PAG Regulus converts them to ordinary shares (at $1.50), it would take control of 47% of Regional Express. We believe this was a bold and risky play by Regional Express that is already paying off. As Baron Rothschild famously said, the best time to buy is “when there is blood in the streets”. The stock is already at $1.64 and based on our four-star rating (spoiler alert), we expect the price to go higher. So, we believe the chances of this convertible debt not being turned into shares is small.

There is one risk we believe is important to point out and that is the price of oil. Stocks Down Under currently has a house view that the price of oil will continue to rise and as a rule of thumb this is generally bad news for the airline industry, which operates on slim margins. If the price continues to climb, we don’t believe it will force Regional Express to repeat a loss for FY22, but it will put a serious damper on the company’s year end result, because the company doesn’t hedge it’s forward fuel requirements.

Still, despite the dilution and oil risk, we believe Regional Express is a solid bet when it comes to a re-opening play. The company already has a solid track record of profitable operations. Twelve years of profits before FY20 is no mean feat in the airline industry. The company has taken full advantage of the depressed industry outlook from COVID-19 to make a strategic expansion we don’t believe has put the company in an untenable financial position. Yes, total debt/equity is now at 87.9% versus FY19’s 3.9% and FY20’s 10.8%, but the vast majority of that debt is the convertible notes we spoke of before.

Therefore, with operations expected to go into high gear starting 15 November 2021 and with a trailing 12-month EV/Revenue multiple of 1.8x (Qantas is trading at 2.8x), we believe Regional Express is a four-star opportunity. Just keep an eye out for that dilution.

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Share price chart

Source: Tradingview

Time for a transition

For most of its existence, the Resources Development Group has relied on its skills in mining construction and contracting to generate revenue for its investors. And while this still remains the company's principal focus, on 12 March 2020, management announced the first step in its transition with the acquisition of the Ant Hill and Sunday Hill manganese projects. A third project was added on 10 December 2020, called Balline, a 'shovel ready' Heavy Mineral deposit focusing on high-quality alluvial garnet.

The mining services division made all of Resource Development's $67m revenue in FY21. While this result represented a 221% increase in revenue year-over-year, don't get too excited as the company's margins are extremely slim. During FY21, the cost of sales alone was $39.4m, or 58.7% of revenue. In FY20 it amounted to 41.6%, while during FY19, cost of sales relative to revenues was 30.9%. Unfortunately, management has not commented as to why these costs have been increasing so drastically and since this trend began before the Balline and Lucky acquisitions, we don't believe these costs are related to the transition the company is making.

Lucky Bay getting lucky!

We noted above the Ant Hill and Sunday Hill manganese project acquisitions. The company is currently in the midst of reviewing these projects, with the latest data released on 1 June 2021 estimating the mineralisation at 5m tonnes at 18% manganese, 22.8% iron and 19.1% silicon oxide. This is broken down further by 4m tonnes being categorised as indicated and 1m tonnes inferred.

On 1 July 2021, Resource Development made a rather impressive announcement, regarding the Lucky Bay Garnet Project. Lucky Bay is the new name for Balline, which produces detrital heavy mineral sand, mainly alluvial garnet in the Mid-West region of Western Australia.

The company is not the first to attempt to work this mine, but it believes its expertise will allow it to succeed where others have not. The latest data saw a 1,520% increase in the company's mineral resource estimate for the mine, following its recent drilling and laboratory analysis program. Management estimates that the project has a Net Present Value of $483m, total ore reserves of 202Mt at 5.4% heavy mineral (HM), split between 10.9Mt of HM and 9.3Mt of garnet, granting an estimated mine life of 29 years.

Float and volume are a major issue

The truth is that Resource Development's free float is slim to none at only 8.7% as of 21 October 2021. This goes a long way to explain the company's extremely thin average daily trading volume over the last three months (710,000 shares), which comes to a daily average trading value of only $35,500. This is actually a lot worse than it seems when you look at the chart and see that the last three months have seen abnormally heavy volume. The average prior to this was well below 250,000 average shares traded per day (most days zero shares were traded).

Resource Development is currently in the midst of a major transition from a mining services provider to a miner in its own right and it seems to be on the right track. However, there is still a lot that could go wrong before either of its currently owned mining operations becomes operational. This does not even include the fact that developing a mining operation is far from cheap and the company's FY21 EBITDA profit of $2.1m won't cut it.

Until we get a clearer picture of how funding will be secured and what is going to happen to its mining services operation, we don't think this company is worth the risk. Three stars.

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Share price chart

Source: Tradingview

Ethical investments, don't stick your head in the sand

Even if this style of investment doesn't float your boat, it would be irresponsible to ignore the trend towards ethical investments as it can have a real impact on your portfolio. Before we go into the major capital flows into this 'new' style of investing, let's take a look at an example of when the emphasis on ethical investing took a bite out of Stocks Down Under's performance.

On 27 August 2020, we rated Cleanaway Waste Management (ASX: CWY) four-stars at $2.43 per share based on our expectation that the market was underestimating the strength shown during FY20's preliminary results released the previous day. Everything was going well and the stock eventually moved to its current price of $2.77 per share, but not before crashing to right above $2.00 after the Australian Financial Review broke the story that its CEO at the time, Vik Bansal, was a physical and verbal bully, and the board was covering it up and lying to shareholders (see 24 May 2021 report). It took until the end of November for the stock to recover from this extreme drop, despite releasing an overwhelmingly positive 2020 Annual Report on 11 September 2020. There are many other examples to choose from, but 2020 proved that the market is more than willing to bash a stock if executives' behaviour is unethical, even if the financial results are strong.

On 7 June 2021, the Australian Financial Review released an article titled, ESG flows dominate, just not in the returns stakes. The name of the article really says it all. From the beginning of 2021 through April, total fund flows into global Environmental, Social and Corporate Governance (ESG) funds was up 193% to US$123bn. In other words, during this time frame, nearly US$3 of every US$10 of global equity inflows was going into ESG funds. For those concerned about an ESG bubble, during COVID-19 you were probably right. But Bank of America has found that stocks with top quintile ESG scores, based on MSCI data, traded at a 20% to 30% premium to bottom quintile stocks several years ago and as high as a 50% premium at the onset of COVID-19. That premium has shrunk to a mere 5% today.

In a nutshell, capital flows into ESG-based funds are increasing, while the premiums these stocks are trading at are decreasing, a likely indication of a long-term, viable trend.

Morphic does not take you for a rube

Morphic Asset Management was founded in 2012 by Jack Lowenstein and Chad Slater, two veterans of Hunter Hall. While there are many (often valid) concerns surrounding 'green washing' and other forms of 'phony' ESG investments, Morphic clearly does not take its investors for a bunch of rubes. Morphic's strategy is simple, invest in an ethical way that lines up with ESG principals. This excludes investments in armaments, tobacco, alcohol, gambling, intensive farming and aquaculture, oil and gas, coal, uranium as well as rainforest and old-growth logging.

Additionally, Morphic's charter would have likely precluded it from tolerating the type of behaviour we mentioned before from Vik Bansal. But how do we know that Morphic plans to stick to its rhetoric? Well, Morphic is a signatory of the Principles for Responsible Investment (PRI) and it is certified by the Responsible Investment Association of Austrasia (RIAA) as ethical investments. Morphic is also a signatory of Climate Action 100+.

If that was not enough, we were quite pleased to find that Morphic Ethical Equities Fund's monthly performance report provides investors with a rather comprehensive overview of how the company has managed to ensure its investments meet the requirements of ethical and ESG investments. In our view, Morphic is doing as much as it can to prove to investors it puts its rhetoric into action.

Strong returns and a discounted NTA

Morphic Asset Management has launched two funds since it was founded in 2012: Morphic Global Opportunities Fund and Morphic Ethical Equities Fund. This article covers the Morphic Ethical Equities Fund, which was founded in May 2017 and invests in international equities that meet Morphic Asset Management's ethical requirements. So far, investors have been handsomely, and consistently, rewarded for their ethical monetary actions as the Listed Investment Company (LIC) has returned an average of 13.4% per year over the last three years (net of fees), beating its benchmark (the MSCI All countries World Daily Total Return Net Index) by 0.8%-points.

Over the last year, the LIC has returned 32.7% (as of September 2021's monthly report) versus the index's 26.5%. However, over the last six months the LIC's returns versus its index have become choppier, but far from catastrophic. It has underperformed its index by 0.9%-points and over the last three months beaten the index by 0.23%-points. Still, on a long-term basis we believe Morphic Ethical Equities Fund has proven its stock picking proficiency, although, as always, past performance is not an indication of future results.

If you are looking for an ethical investment that does not force you to analyse the ESG credentials of each company, we believe Morphic Ethical Equities Fund has what you are looking for. The stock is currently trading at $1.325 and has paid out $0.025 in dividends in July 2021 and with a post-tax NTA of $1.38 per share as of 15 October 2021, we are giving this fund a four-star rating.

Pitt Street Research Pty Ltd

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