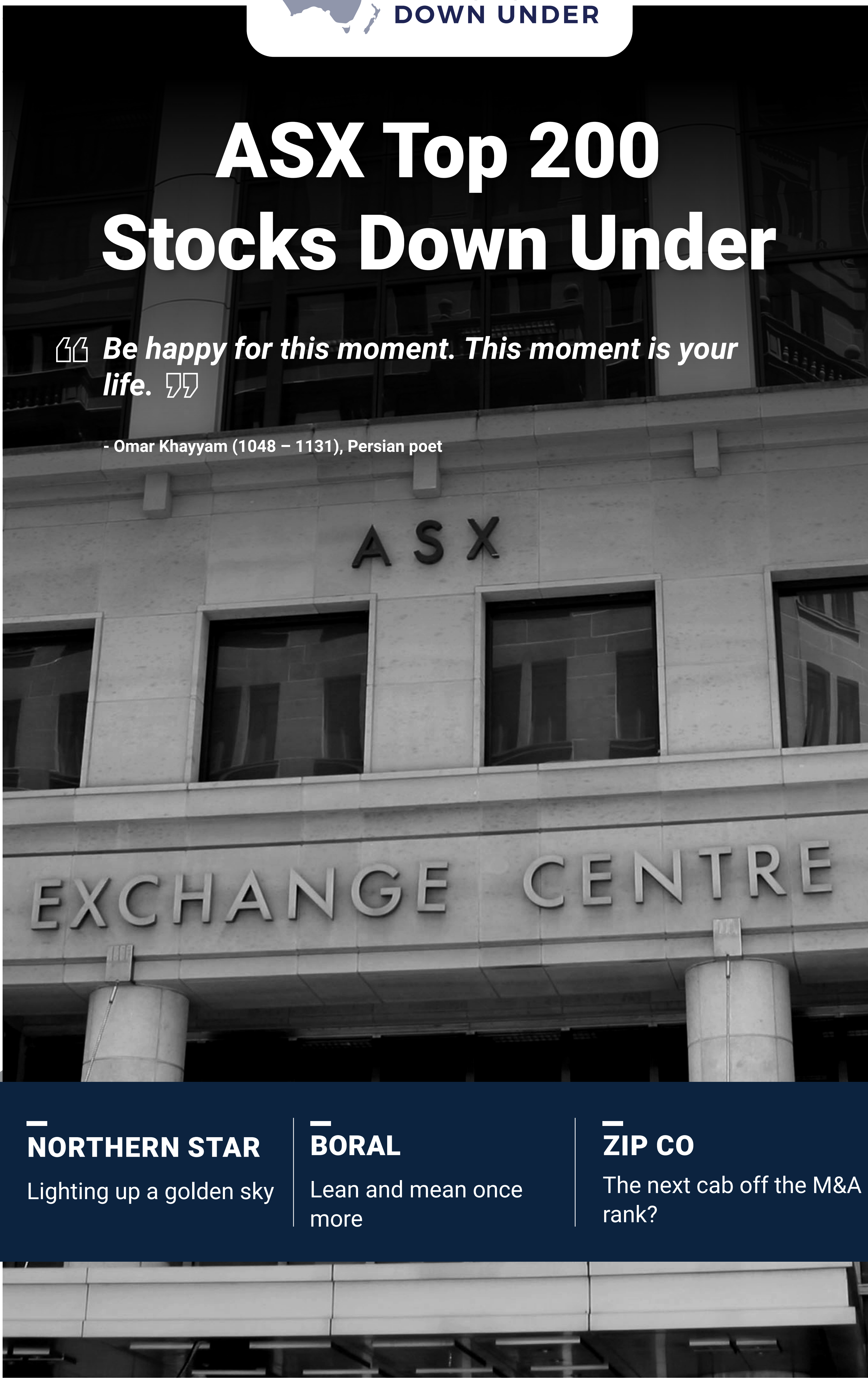
STOCKS DOWN UNDER

15 NOVEMBER 2021

ASX Top 200 Stocks Down Under

> *Be happy for this moment. This moment is your life.*
>
> - Omar Khayyam (1048 – 1131), Persian poet



NORTHERN STAR

Lighting up a golden sky

BORAL

Lean and mean once more

ZIP CO

The next cab off the M&A rank?

NORTHERN STAR

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Stocks Down Under rating: ★★★★

ASX: NST
Market cap: A$12.4BN
Dividend yield: 1.8% (100% Franked)

52-week range: A$7.96 / A$15.24
Share price: A$10.61

When we last wrote about Northern Star Resources on 14 August 2020 the stock of this gold miner was riding high, at above $14 a share off the back of a strong gold price. We only called it three stars because we were worried about what the hedge book would do to future shareholder value if the gold price continued to increase. Since then, gold has eased back, but the company has merged with Saracen to create a globally significant gold mining company and the future outlook, including the hedge book, is looking good. As of today, we're upgrading Northern Star to four stars.

READ MORE

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ASX: BLD
Market cap: A$7.2BN

52-week range: A$4.72 / A$7.43
Share price: A$6.50

If you are not familiar with Sydney-based Boral, as one of the largest suppliers of construction material in Australia, the chances are you have trusted your life to its work. The company has had it tough over the last few years, but Chairman Ryan Stokes has done a fantastic job reworking the company to the lean and mean machine it is today. A large part of that was divesting over $3bn in assets, mostly used to reduce debt to a more manageable level, but also used to fund share buybacks. But the question remains, has all this good news been priced in already?

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52-week range: A$4.96 / A$14.53
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Share price chart

Source: Tradingview

The timing couldn't have been better for Northern Star in terms of effecting its merger with Saracen. The deal was announced on 6 October 2020 and completed on 12 February 2021. Over that time gold was gradually easing back, but the yellow metal turned around again not long after the two companies were finally put together. That left the enlarged company to enjoy the upside from a combined 1.6 million ounces of production headed to 2 million ounces by the middle of the decade. By which time gold could potentially be a lot higher than the August 2020 peak.

Headed for 2 million ounces a year

The first thing to like about the new Northern Star is that sovereign risk is not an issue. It's currently working towards 1.1 million ounces of gold a year from mines in and around Kalgoorlie, including the legendary Super Pit, of which it now has 100%. Another 600,000 ounces or so will ultimately come from three mines in the Yandal Greenstone Belt in WA. And then there's the Pogo Gold Mine in Alaska, which Northern Star acquired in 2018 and for which the company is targeting 300,000 ounces a year. We think this insistence on only being in safe, Tier 1 jurisdictions will stand Northern Star in good stead in the uncertain decade ahead.

The second thing to like about Northern Star is the cost base and the resulting margins. The company is guiding to 1.55 to 1.66 million ounces of production in FY22 at an All-In Sustaining Cost (AISC) of just A$1,475-1,575 per ounce, which translates to US$1,105 to US$1,180. Around 800,000 ounces in total – a mere six months' worth of production – have been sold forward at between A$2,280 and A$2,310 an ounce. The rest is all coming from Northern Star at what it expects will be a gradually rising spot price in the years ahead.

56 million ounces and counting

The third thing we appreciate about Northern Star is the balance sheet. The company had A$771m in cash and cash equivalents and bullion per the end of September 2021, but only A$262m of corporate bank debt, so it has plenty of firepower to go after new mines, or to acquire other miners at the right price.

And then there's the long-term nature of the assets. As at March 2021 Northern Star's total JORC 2012 resource was 56 million ounces and its reserve was 21 million ounces. We see the company adding to this resource and reserve position in the years ahead thanks to the strong exploration potential of the regions in which it is active. But even if it rested on its laurels and just converted resources to reserves it's more or less got a couple of decades worth of production in the bag.

Super Pit, super potential

A lot of that upside has to do with the Super Pit, that gigantic open pit gold mine on the south-eastern edge of Kalgoorlie, which is sometimes called KCGM, short for, Kalgoorlie Consolidated Gold Mines. The Super Pit represents Alan Bond's 1980s consolidation of a number of old underground gold mines into one large open pit with superior economics. When Bondy went belly up, Homestake and Normandy started reaping the upside from 1989. Today, the Super Pit is one of the largest gold mines in the world.

For a long time, the Super Pit was owned by absentee landlords, but in 2019 that changed. Barrick, which got Homestake's share, sold to Saracen for US$750m while Newmont, which inherited the Normandy half, sold that to Northern Star for US$800m. Both companies bought cheaply because of rock falls in May 2018, which hampered production for a while. Looking ahead, we think the sky is the limit. The Super Pit produced a massive 730,000 ounces of gold in the 2017-18 financial year and by FY28 Northern Star expects to be back at 700,000 ounces.

But it's the long life of the asset that impresses even more. The current resource at KCGM is 26 million ounces, but no one knows what resources really lie beneath the Super Pit because the mineralisation remains open at depth.

FY22 represents the first full year of the merged Northern Star/Saracen entity. On consensus numbers Northern Star will grow earnings markedly by 17% in FY23 thanks to production increases and better gold prices. However, the EV/EBITDA multiple on FY23 consensus estimates is just 6.4x. That's low given the potential of gold in the years ahead.

The surge in inflation around the world, driven by COVID-induced shortages and large expansions in central bank balance sheets, is driving the search for inflation hedges. And while crypto currencies have done well in this environment, we see gold as the 'Original Crypto' that will also increase in value in this inflationary environment. With gold likely headed up, and Northern Star at a bargain basement price, we're switching it to four stars.

In fact, we like Northern Star so much that we included it in Marc & Stuart's Top Picks on Thursday 11 November.

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Share price chart

Source: Tradingview

A new lean, mean Boral machine

Before we really dive into Boral, what exactly does the company do? At its core, Boral is a provider of construction materials, mainly cement and asphalt, to the Australian construction industry. Boral has been around for over 75 years and currently operates 367 sites, approximately 4,600 contractors and 3,500 heavy vehicles. At $2.9bn in revenue from continuing operations during FY21, this is certainly no mom-and-pop operation.

And that brings us to a point of clarification that we need to make about Boral. In the last few years the company got seriously offtrack and when Chairman Ryan Stokes (also the Managing Director and CEO of Seven Group | ASX: SVW, see 14 May 2020 report) took up his position in 2020, he had his work cut out for him. To illustrate the point, during FY21, Boral's total revenue amounted to $5.3bn, but in order to pay down its debt and refocus on what it does best, Boral sold off over $3bn in assets. So, when we talk about Boral's earnings, we are specifically talking about continuing operations, not total results.

Currently, I main source of revenue by end market for Boral is roads, highways, subdivisions and bridges (FY21: 42%), with 43% generated in New South Wales and the Australian Capital Territory. While this was bad new during FY20 and FY21, NSW is now a leader in vaccinations in Australia, meaning lockdowns should be a thing of the past for the state. With construction booming once more in NSW, we believe Boral will see strong growth there.

So now that we know the largest source of end market revenue for Boral, what about the other 56%? Well, non-residential is the second largest at 18%, but the remaining 38% is split between detached housing, alterations and additions, multi-residential, other engineering and other. While cement is used heavily in roads, it is important to remember that it is a product used across all types of construction. Roads, highways, subdivisions and bridges will always remain the largest source of revenue for Boral, but the company has strong exposure to the rest of the construction industry as well.

It's time to return capital once more

Boral has had a tough time over the last few years and the pandemic did little to help. Basically, the company pilled on a significant amount of debt, which caused dividends to be temporarily suspended. It is important to note that the share price has not really suffered. In fact, by early 2021, the share price had rebounded to above $5.70, not seen since late 2018.

Part of this rebound came after the Seven Group increased its holding in Boral from 19.99% to 70% in July 2021 after its takeover bid of $7.40 per share. Boral stock sank following this increased holding by Seven Group, but we think Seven Group's track record of acquiring valuable franchises at a reasonable price suggests that Boral can return to this level.

Now that net debt is back to approximately $900m, with S&P affirming a BBB credit rating and stable outlook on 1 November 2021, management is ready to resume shareholder capital distributions. While it has not commented yet on the exact method of returning approximately $3bn in excess capital, we believe it will likely be a combination of additional share buybacks and a resumption of dividends.

The market is divided

Boral has just finished a massive restructuring and the market is clearly uncertain as to how profitable the company will be going forward. For FY23, EBITDA growth rates range from 24.9% negative to an increase of 48.9% compared to FY22's median consensus EBITDA of $677.6m (FY21: $406m). Our view is that in 2021 the restructuring has proven that the company is back to being a lean and mean machine. And therefore, we tend towards the higher estimate, especially when we factor in the construction boom that is ongoing.

Currently, the market seems to be split down the middle, valuing Boral at an FY23 EV/EBITDA multiple of 12x. We believe that this is likely too low, especially once you factor in the approximately $3bn in excess capital returns announced during the Annual General Meeting. Yes, it is unclear how the capital will be returned to shareholders, but as we said before, we believe it will likely be a combination of share buybacks and a resumption of the dividend. Completed in July 2021, Boral bought back 10% of its outstanding shares at an average price of $7.01 per share, higher than the stock is trading at right now. Therefore, factoring all of this in, we believe Boral is a four-star stock, despite the market's trepidation.

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Share price chart

Source: Tradingview

In the Top 6 most shorted stocks

Let's start off with the bad news first. Zip is among the most shorted stocks on the ASX. Shorting a stock means selling shares that you don't actually own and buying them back when the share price has declined. Institutional investors can do this by borrowing stock and then selling it on market. Retail investors can really only do it through put options.

According to ASIC data for 4 November, Zip Co was the sixth most shorted stock on ASX. In total, 51.3m shares have been sold short, or 9% of the outstanding shares. That's not as high as the 66.5m (11.8%) short interest at the end of July this year, but it is still a very sizable number. The bottom line is that there is a big group of investors out there that think Zip can go lower than where the price is today.

ZIP's value to a potential buyer

We won't bore you with Zip's customer and merchant numbers, Total Transaction Volume and revenue. Just have a look at the recent AGM presentation for that. All these metrics are growing triple digits, so nothing to worry about there. We believe the reason for Zip's underwhelming share price performance since mid-February this year, when it peaked at $14.53, is the increasing competition in the BNPL space globally. PayPal's entrance into this market is probably the strongest piece of evidence of this.

However, with the share price approaching $5.00, we'd argue that Zip is becoming interesting again. Not only is the valuation coming back down to more reasonable levels, but following the recent takeover of AfterPay by Square, we believe Zip is probably the next best company to buy if you're a global bank or FinTech looking to get into the BNPL space. Zip has an installed base of more than 55,000 merchants and 8 million customers worldwide. And in the last twelve months, it bought its way into the US market with the acquisition of QuadPay and it entered the UK, Canadian and Mexican markets, while it expanded its position in twelve European countries. Part of that European expansion is through acquisitions. On 12 November 2021, the company announced it had completed its acquisition of Twisto Payments, active in Central Europe, for $116m. That's got to be worth a lot to the right buyer, especially if you can supercharge Zip's growth by throwing more capital at it. But even standalone, we think an investment in Zip makes sense at the right price.

EBITDA profitable in 2023

Consensus estimates tell us that Zip should reach EBITDA profitability in FY23. In that financial year, the company is expected to bring in $84.5m in EBITDA versus an EBITDA loss of $33.4m in the current financial year. The following year, so FY24, EBITDA is expected to grow by 82%, to $153.6m.

Those numbers imply Zip is currently trading at EV/EBITDA multiples of 58.9x and 32.4x for FY23 and FY24 respectively. While FY24 is still some way off, FY23 starts in seven months. And we have seen valuation multiples for AfterPay reach a lot higher in the run up to EBITDA profitability. Granted, AfterPay is the global leader in this industry, so a premium is warranted. But we think Zip as an investment has merits too, although it is not as large as AfterPay. The 82% EBITDA growth in FY24 looks very attractive in light of the EV/EBITDA valuation of 32.4x for that year.

Additionally, the aforementioned M&A value is something we think potential suiters will be willing to pay for, similar to why Square got out its check book to get its hands on AfterPay.

Wait and see if the $5.00 support level holds

In terms of timing, Zip shares are still in a downtrend. If you look at the price chart, a technical analyst will tell you that $5.00 is a crucial support level that needs to hold. Otherwise, there is a gap to around $3.70 that may get filled. So, for now we'd wait and see how Zip shares behave around the $5.00 level, that is, if and when it reaches that level.

If that support level holds, we believe Zip could be a very interesting investment in the BNPL space. It is one of the larger independent pure plays with a presence in the United States. We think it's likely someone will come knockin'. Four stars from us if and when the $5.00 level holds.

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.