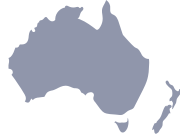

22 NOVEMBER 2021

ASX Top 200 Stocks Down Under

> *Your words may be correct, but they are no less unwise.*
>
> **- Yulian Kuznetsov (in Nobody), American movie**

SOUTH32
Diversified miner personified

NINE ENTERTAINMENT
Welcome to the 21st century

LOVISA
Still shining

SOUTH32

Diversified miner personified

Stocks Down Under rating: ★★★★

ASX: S32
Market cap: A$16BN
Dividend yield: 2.7% (100% Franked)

52-week range: A$2.27 / A$4.07
Share price: A$3.51

Headquartered in Perth, we last wrote about South32 on 5 May 2020, rating the stock a four-star turnaround story at $1.83 per share. Well now the stock is up 90.7% on the back of massive share buybacks and the opening salvo of a new upswing in the commodities cycle. What really sets South32 apart from other explorers, however, is its mineral diversification. We believe, however, South32 has reached the point where the market may take its foot off the accelerator and may just start cruising higher rather than speeding higher.

READ MORE

NINE ENTERTAINMENT

Welcome to the 21st century

Stocks Down Under rating: ★★★

ASX: NEC
Market cap: A$5.2BN
Dividend yield: 3.4% (100% Franked)

52-week range: A$2.25 / A$3.16
Share price: A$3.02

We last reported on Sydney-based Nine Entertainment on 28 April 2020 and it has certainly been an interesting year for the company. Earlier this year, Nine Entertainment had the unfortunate reality thrust upon them of 'being the story' instead of delivering news stories when the company was hacked and heavily disrupted. This hack was not a small feat as this is a major Australian media organisation. As if that wasn't enough, a recent High Court ruling adds some additional risk. However, Nine Entertainment has done something that not many media companies have, a successful transition into the 21st century.

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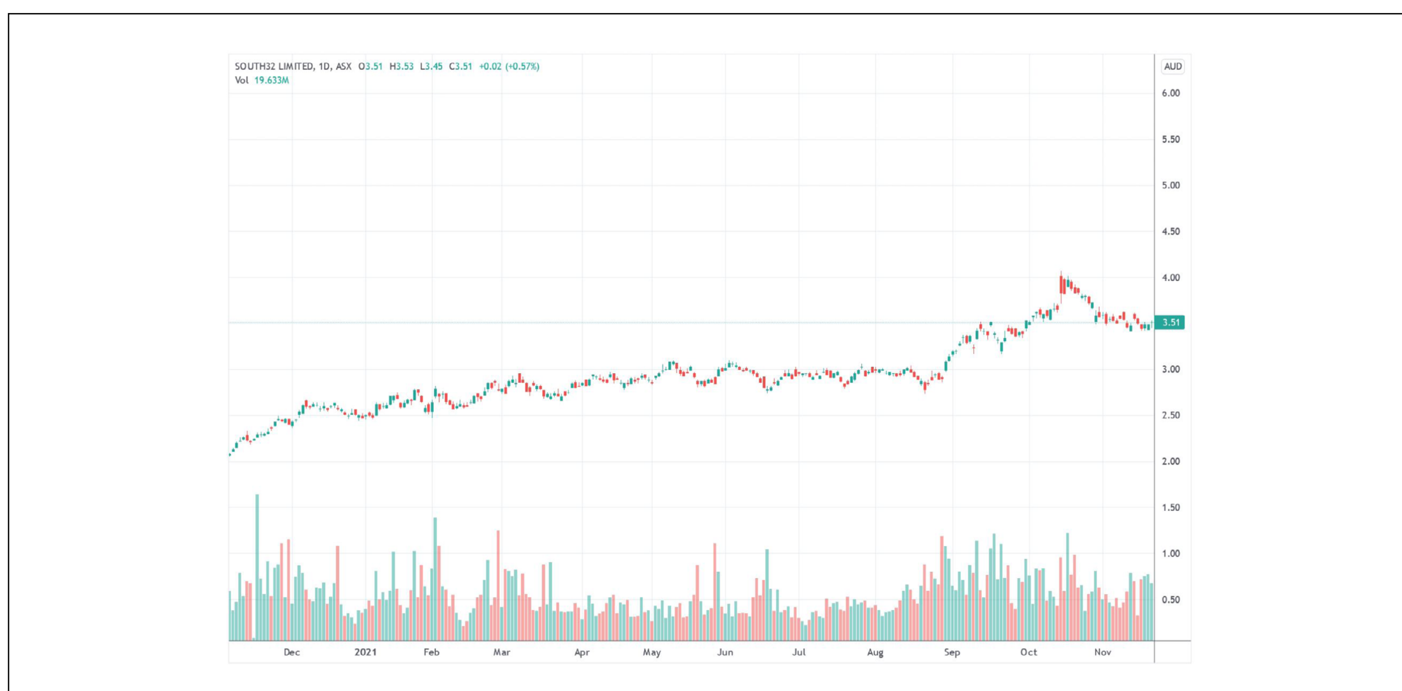

Source: Tradingview

If I could have all the minerals in the world

At Stocks Down Under, we have covered a number of diversified mining and metals operations before, but South32 truly embodies what it means to be diversified. With operations in Australia, Southern Africa, Europe and the Americas, the company produces alumina, aluminium, bauxite, metallurgical coal, lead, nickel, manganese, silver and zinc. And as if that was not diverse enough, on 14 October 2021 South32 announced it was getting into the copper production game with a 45% interest in the Sierra Gorda copper mine for US$1.6bn in cash (there are provisions for an additional US$500m payment over four years). While the main reason for this purchase is gaining exposure to copper (total production of 214 kilo tonnes estimated for CY21), the mine also is expected to produce five kilo tonnes of molybdenum, 54 kilo ounces of gold and 1,573 kilo ounces of silver during CY21 in total.

However, since South32 produced 3,493 kilo ounces of silver during 1Q22 alone (without any input from Sierra Gorda), the only materially relevant part of this mine is the copper production, which at the current price of US$9,495 per tonne, if South32 had owned its 45% stake at the beginning of CY21, it would be generating an estimated US$914m on the copper alone.

At Stocks Down Under we are highly bullish on the price of copper over the next few years as it is one of the main metals behind the transition to a green economy and we expect the price to continue to rally significantly higher in the long-run.

Strong EBITDA growth in FY21

During FY21, South32 generated US$1.6bn in EBITDA on US$6.3bn in revenue. Compared to FY20, this represented 32% and 4% gains year-over-year respectively, although, this does include US$861m in revenue from South Africa energy coal, which the company has since sold.

A bit of a warning, we are about to throw a bunch of numbers at you, but bear with us, it's important to know. In South32's annual report the company released the estimated impact on its underlying EBIT if there was a positive or negative 10% change in the price of each of its commodities under production (excluding copper). These numbers are as follow: aluminium US$208m, alumina US$155m, manganese ore US$91m, metallurgical coal US$71m, nickel US$43m, silver US$33m, lead US$23m and zinc US$16m. Underlying EBIT excluding South Africa energy coal was US$994m during FY21.

Eating up shares like Pac-Man

On a year-over-year basis, South32's dividend for the October 2021 period increased almost as much as its share price at 82.9% to $0.075 per share. And yet, the company is so flush with cash that it still has plenty to spare, leading management to opt for the other popular way of returning cash to shareholders, on-market share buy-backs.

Now, South32 is no stranger to buy-back. In fact, the current program is based off an Appendix 3C submitted to the ASX on 27 March 2017. Since then, management has bought back over 664m shares for a total payout of over $1.9bn, with the highest price paid on 5 October 2018 at $4.235 per share and the lowest on 13 March 2020 at $1.625 per share.

The program is still going strong, with the latest notification dated 18 November 2021 stating an additional US$214m is authorised for the current buy-back program. The company's ASX announcements page is littered with buy-back notifications, out of a total 14 possible days in November so far, 12 have a daily buy-back market announcement usually between $800,000 and slightly over $2m spent in on-market share purchases.

Looking into the glow of the future

The only commodity in South32's production portfolio that we are not overtly bullish on in the long-run at Stocks Down Under is metallurgical coal, but we are bullish in the short-term. We expect shortages will continue and the price will continue to increase. In the long-term, though, we believe the situation is more uncertain. However, this is not a large concern for South32, because, as we discussed above, the company's three largest EBIT sensitive commodities are aluminium, alumina and manganese ore. A 10% positive move in price across these three would result in approximately a US$454m increase in South32's EBIT.

When it comes to the future earnings of South32, the market is unified that FY22 will see a sharp increase in EBITDA, but the 18 analysts are divided as to what FY23 and FY24 will look like. Still, the median estimate has EBITDA rising 114% to US$3.4bn during FY22, before falling to US$2.6bn during FY23.

However, even if we assume the EBITDA decline during FY23 is accurate, we still believe South32 is trading below fair value at FY22 and FY23 EV/EBITDA multiples of 3.5x and 4.1x, respectively. Combine this with the massive buy-backs and an expected bump in divided during FY22, and South32 is a solid four-star stock in our book.

NINE ENTERTAINMENT

Welcome to the 21st century

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Share price chart

Source: Tradingview

Transitioning is one of the hardest things to do

Worldwide media is going through a massive transition and many outlets are finding out they are just not up to snuff. This includes the massive media empires all the way down to the small-town newspapers. The debate still rages on about how to successfully monetise digital offerings, but one company has shown itself to be, if not in the know, then certainly ahead of the pack.

Nine Entertainment has a vast Australian-focus multi-media empire, ranging from television, to radio, podcasts, online and print. The company's Chairman, the legendary Peter Costello, has been working hard to push Nine Entertainment in the direction of digital offerings, and in our view has been highly successful.

During FY21, the company generated $2.3bn in revenue (8% growth year-over-year) and $564.7m in EBITDA. The company's revenue is split between broadcast (51%), publishing (22%), Stan (14%), its investment in Domain (8%) and 9Now (5%). The highest growth came from the broadcast division, although this comes as no surprise when you consider the massive hit advertising took during FY20 when COVID-19 first hit. It is important to note Chairman Peter Costello's comments that advertising significantly rebounded from its initial slump and that the company's advertising growth projections are higher now than they were before COVID-19.

The publishing business is the second largest source of Nine Entertainment's revenue and reached an important milestone during FY21, with 56% of its revenue now generated through digital sources and 30% from subscriptions. Publishing is, of course, one of the main areas of concern when it comes to media companies successfully transitioning into the 21st century and it truly is a mark of just how successful Nine Entertainment has been that FY21's EBITDA of $117m is higher than it was during FY19.

2021: a hack and an unfortunate High Court ruling

The year 2021 has not been kind to Nine Entertainment, despite COVID-19 and geopolitical tensions providing a boon for news media. Firstly, the company was hacked during the weekend of 27 March 2021 and then on 8 September 2021, the High Court potentially turned Australian media companies' social media strategy upside-down when it found them liable for the comments on their Facebook posts.

While the hack has already well and truly been accounted for and priced in, the consequences of the Hight Court ruling are still far from certain. According to analysis published by the University of Sydney Law School on 13 September 2021, the High Court ruling in the 'Voller' case does not just cover Facebook comments, but all social media and allows for anybody who runs a social media page to "theoretically be sued over disparaging comments posted by readers or random group members — even if you aren't aware of the comment".

Additionally, "the case focused on Facebook, but the implications are not Facebook-specific. It can apply equally to Twitter, Instagram and other social media too — or websites (such as The Conversation) that have comments sections". During his Annual General Meeting address on 11 November 2021, Nine Chairman Peter Costello made it clear that Nine Entertainment's focus was on transitioning more towards digital, but made no mention of this new risk for his sector. Australia's libel laws are notoriously sided towards the plaintiff and so, in our view, this ruling offers a risk that is both not commonly known nor acknowledged by the market.

Impressive company, but the valuation is too entertaining

By now you can tell that we are fans of Nine Entertainment's ability to drag itself past its competition into the 21st century and towards EBITDA growth. The market clearly agrees with the current consensus forecasting EBITDA will grow 11.5% to $629.5m during FY22 and 8.1% during FY23. While EBITDA growth is currently expected to decline during FY24 and FY25, the market is still forecasting EBITDA to grow, but at a lower rate. We would point out it is a lot harder to predict media growth (three to four years out) than it is one or two years and we are significantly less confident about the market's FY24 and FY25 consensus forecasts.

Using FY22 and FY23's consensus EBITDA growth forecasts gives us an EV/EBITDA multiple of 9.5x and 8.8x, respectively. We believe these multiples are on the high side of fair valuation, especially when you factor in the fully franked indicative dividend yield of 3.4%. So, while we're generally optimistic about Nine's prospects, albeit a little wary about the risks posed by Voller, we can't yet bring ourselves to be really bullish on this one yet. So, three stars.

LOVISA

Still shining

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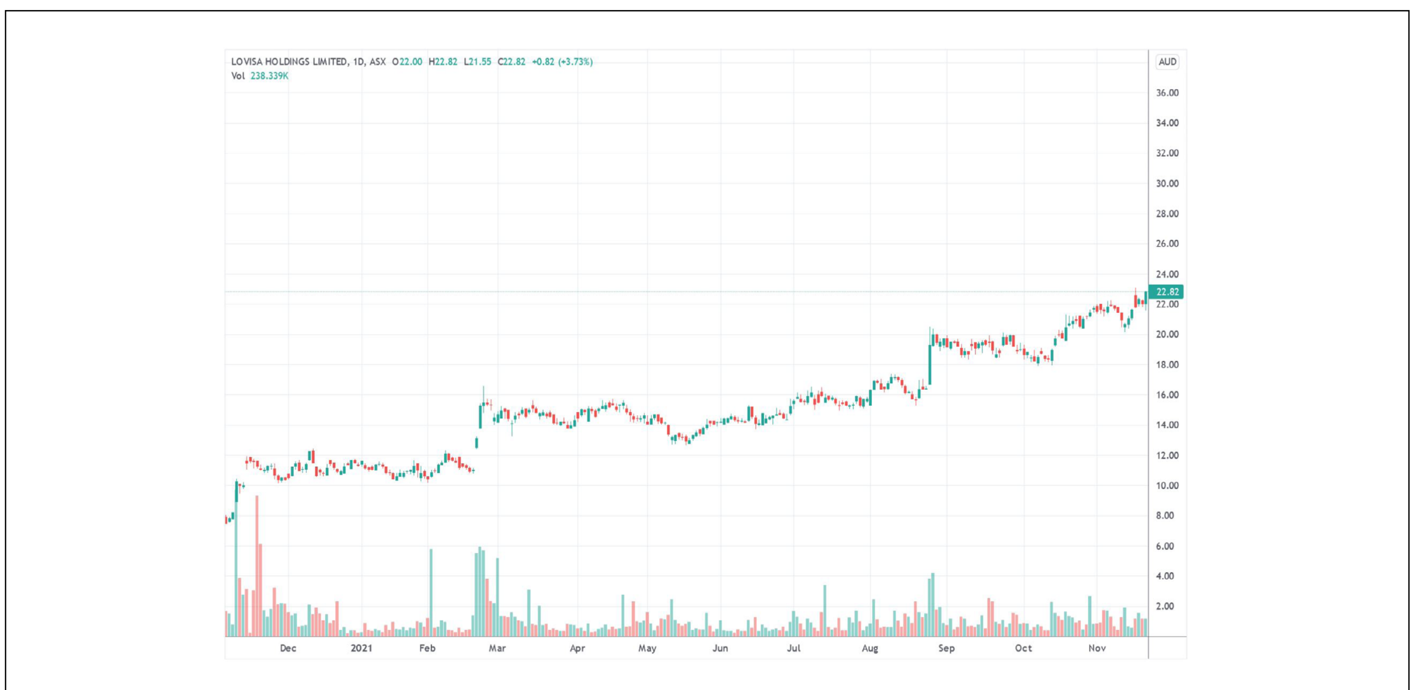

Source: Tradingview

Didn't you recommend getting out of the stock?

Yes, Lovisa was one of the original members of Marc & Stuart's Top Picks list, included on 10 March 2021 at $14.67 per share. However, we decided to remove the stock from our Top Picks list when the price reached $19.47, booking a 32.7% profit.

This was far from a bearish sign and not only did we move the stock to our watchlist, but we stated "we still like Lovisa as a company… we expect mostly sideways trading in the next 4 to 5 months, so it may be dead money for a while. We think we should put that money to better use elsewhere". We were right about the stock price, at first. By 11 October 2021, the stock price had slipped slightly to $18.41, before rallying to its current price of $22.82 per share, 17.2% higher than when we moved it to the watchlist.

Still, short-term price movements are notoriously difficult to predict and even with hindsight, we believe we made the right call in taking Lovisa off our Top Picks list.

COVID-19 can't keep down our need for bling

Our more recent subscribers, however, may be thinking, what exactly is Lovisa? To put it simply, Lovisa is a global retailer that sells cheap jewellery, famous for its five for $20 deal. However, the story is far from that simple, because while Lovisa's jewellery is priced cheaply, the look, quality and marketing behind the products are anything but cheap.

While we are certainly not fashion experts, we believe Lovisa's jewellery advertisements are difficult to distinguish from those of the more expensive, 'higher-end' brands. In a nutshell, Lovisa's strategy is to sell bulk jewellery for cheap prices while making the customer feel like they are getting the deal of a lifetime.

This strategy has been paying off handsomely for Lovisa. During FY21, revenue rebounded to $288m, 18.9% year-over-year and 15.1% compared to FY19. Gross profit increased 18% year-over-year to $221m, 9.7% higher than FY19, but due to significantly higher salary expenses (as the company opened 109 net new stores during FY21, 544 total now), EBITDA declined 3.4% to $60.2m compared to FY19. However, when we factor in the trading update and outlook provided in Lovisa's 25 August 2021 FY21 results presentation, it becomes clear that FY21's aggressive store expansion was clearly the right call.

Trading for the first eight weeks of FY22 was extremely strong with same store sales up 37.8% and total sales up 56%. This is especially impressive when we consider that, excluding the increase in employee costs, all results during FY21 were a substantial improvement compared to FY19. Clearly, COVID-19 can't keep down our need for bling.

However, there was one major point of caution outlined in this section of FY21's presentation; the global transportation crisis is really starting to bite Lovisa and while it opened seven net new stores during the first eight weeks of FY22, it is expecting new store numbers for 1HY22 to be considerably constrained due to logistical bottlenecks. This is far from disastrous news, but it does mean that Lovisa's potential growth will be constrained during the period, a point we believe the market has already factored into its pricing of the stock.

The future is all dolled up for Lovisa

The current market consensus puts FY22 and FY23 EBITDA growth at 34.3% and 28.3%, respectively. In fact, the market currently expects EBITDA to continue to grow at over 20% annually through 2025, and yet, the stock is currently priced at an EV/EBITDA multiple of only 19.9x and 15.5x for FY22 and FY23, respectively.

We believe the current disconnect between the market's expected growth and Lovisa's valuation is the supply chain risk we mentioned above. However, we believe the market is overreacting to the potential reduction in year-over-year growth this may cause in FY22. Yes, it is an issue, but it will mostly affect the opening of new stores, not hurt existing ones, which saw a 37.8% increase year-over-year during the first eight weeks of FY22.

Yes, Lovisa does rely on new stores to help fuel growth, but with its current operations clearly firing on all cylinders and new stores openings expected to slow during 1HY22, not stop, we expect the existing operations can more than pick-up the slack. Four stars.

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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