STOCKS DOWN UNDER

31 JANUARY 2022

ASX Top 200 Stocks Down Under

I still have dreams. Politics without dreams – it would be a nightmare.

- Donald Tusk (b. 1957), Polish politician and former President of the European Council

ASX

EXCHANGE CENTRE

WESFARMERS

Turning old into new

CHALICE MINING

Waiting for the scoping study

HOME CONSORTIUM

Not home yet

WESFARMERS

Turning old into new

Stocks Down Under rating: ★★

ASX: WES
Market cap: A$57BN
Dividend yield: 3.5% (100% Franked)

52-week range: A$47.39 / A$64.98
Share price: A$52.74

We last reported on Perth-based Wesfarmers on 29 March 2021, rating the stock three stars. Since then, the stock has performed mostly along our expectations. A lot has changed since we published our report and as we will explain, Wesfarmers is no ordinary retailer due to its massive diversification and expanding involvement in other investments. But the question we need to answer is whether the changing economic landscape and the company's expanding investments make Wesfarmers a worthwhile investment?

READ MORE

CHALICE MINING

Waiting for the scoping study

Stocks Down Under rating: ★★★★

ASX: CHN
Market cap: A$2.6BN

52-week range: A$3.55 / A$10.00
Share price: A$7.58

It should come as no surprise that Chalice Mining, a company that owns and operates palladium, platinum, nickel, copper and cobalt, is headquartered in the unofficial mining headquarters of Australia, Perth. The company's announcement that it had discovered palladium in Australia was a game-changer. This has led Chalice Mining's shareholders to experience 88% growth over the last year, in what would make any investor ecstatic. But every company has a threshold where the valuation becomes too much. Is Chalice Mining there yet or does it still have room to run?

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Dividend yield: 1.8% (50% Franked)

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When we last reported on Double Bay, New South Wales-based Home Consortium on 17 August 2020, the company was a 'simple' Real Estate Investment Trust (REIT). Since then, the trust's valuation has doubled and so too have the trust's operations. After spinning off HomeCo Daily Needs REIT and HealthCo Healthcare and Wellness REIT, the trust has transformed into a fund management company, although its remaining investment properties are still an important asset. The big transition has changed how Home Consortium operates and how we value the company. So, let's dive in and see where we currently stand.

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Share price chart

Source: Tradingview

It's basically Bunnings and 'Other'

Wesfarmers is a massive company, generating $34bn in revenue and $5bn in EBITDA in FY21 through six divisions. Over the last three years, the stock has been on an almost straight, upward climb with a few, often significant, corrections. After the market's recent rout, Wesfarmers is in the middle of such a correction, but Omicron is still here looking to cause trouble. But we believe Wesfarmers' operations are insulated enough to withstand the turbulence.

By far the largest source of revenue and profit for Wesfarmers, both in FY21 and the few years prior, has been Bunnings, generating $17bn in revenue and $3bn in EBITDA in FY21. And don't let the large numbers fool you, Bunnings is still growing. In FY21, revenue and EBITDA grew 13% and 15%, respectively.

The Bunnings division is comprised of three sub-divisions, Bunnings, Bunnings Warehouse and Bunnings Trade, and Adelaide TOOLS - a broad tools retailer operated through five South Australian stores and the company's online shop.

In FY21, same-store sales growth was 12% and online penetration as a percentage of customers increased 1.4%-points to 2.3%. Online penetration is still low, yet grew so rapidly, because Bunnings launched a new retail website and invested heavily in the year to increase digital analytics. Part of this investment was ensuring over 100,000 products are now available online.

Still, while we believe these investments will benefit the company in the long run, we expect a pullback as far as FY22 is concerned. Our logic here can be broken down into two points. The first is the most concrete, being Wesfarmers' management commentary. In the company's FY21 report published on 27 August 2021, management stated, "trading performance in FY22 is expected to moderate following the extraordinary growth recorded in FY21". At the time of the report, FY22 year-to-date revenue had declined 4.7% year-over-year, although demand from commercial customers continued to be strong. Our own analysis at Stocks Down Under agrees with Wesfarmers's management. Retail demand has drastically come down in FY22 to-date as the renovation craze among retail investors post the first COVID-19 lockdown has abated and inflation has created additional uncertainty.

The 'Other' division is still fairly significant

The Kmart Group division is comprised of three sub-divisions, Kmart, Target and catch.com.au. Combined, this division generated $9.5bn in revenue (7% growth) and $1.3bn in EBITDA (23% growth) in FY21, with the majority of revenue and future growth generated by Kmart. This division is one that is important to look at closely in the future. Why? Wesfarmers' management has decided to drastically simplify the Target sub-division by converting them to Kmart stores and closing other stores.

We believe this simplification strategy explains why EBITDA increased so rapidly compared to revenue in FY21. The catch.com.au sub-division went from generating an EBITDA profit of $20m in FY20, to a loss of $24m in FY21, but this was a loss by choice. Wesfarmers decided to double its head office count and drastically increase marketing costs. This strategy seems to have already born fruit as revenue increased 45% to $528m. Unfortunately, FY22's outlook for this division is not looking so good either, but this has more to do with the ongoing supply chain issues than a lack of demand.

The Officeworks division is the last of the old divisions of any significance to Wesfarmers' total results, generating $3bn in revenue (9% growth) and $328m in EBITDA (7% growth) in FY21. This division comprises two sub-divisions, Officeworks and Geeks 2 U (a computer repair company), and the main focus of both in FY21 was to increase the use and capability of its respective online offerings. So far, this strategy seems to be paying off as the division's online penetration increased 5.3%-points to 35.2% year-over-year.

Ignore FY22, onwards to FY23 and FY24

If there was one thing that should be clear from our analysis above, it's that FY22 results will most likely see a slight pullback due to the increasing supply chain pressures and lower demand facing the Bunnings division. FY22 is over halfway done at this point and from a valuation standpoint we think it makes the most sense to simply skip FY22 and move forward to FY23 and FY24, especially since a decline in FY22 is not a negative result, but rather showing just how strong FY21 was.

The current market consensus sees EBITDA decline in FY22, but the market also believes FY23 will see it immediately bounce back. Consensus estimates call for FY23's EBITDA to grow 2.7% compared to FY21 and then 5.6% in FY24 versus FY23. This results in FY23 and FY24 EV/EBITDA multiples of 12x and 11.4x, respectively.

We believe Wesfarmers does deserve a premium and despite the recent correction, we believe the stock still has a ways to go based on its current valuation. The stock currently has an indicative dividend yield of 3.5% and while it is fully franked, we don't believe the stock is good enough to warrant such a high valuation multiple when EBITDA growth is expected to be so modest in the next few years. Therefore, we think the correction still has some distance to go. Two stars.

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Share price chart

Source: Tradingview

A long way from 2006

Chalice Mining was formed in 2006 and listed on the ASX the same year. However, it was not until the last two years that the stock came into its own. One of the main catalysts was the first major discovery of palladium at the company's Julimar mine in Western Australia in March 2020. Since then, the stock has well-deservedly shot through the roof and finally joined the ASX 200 index in June 2021, a milestone virtually unheard of among mineral explorers, even on the ASX.

The palladium discovery changed more than just the company's standing on the ASX. It also changed its focus. In July 2021, management announced it was planning to demerge its Australian gold mine assets. The demerger was completed on 7 December 2021, with Falcon Metals (the new company) raising $30m in an oversubscribed IPO in late December. As they say, the past is prologue and with the demerger complete, Chalice can now focus on Julimar, especially since the mine is not yet operational.

Nickel, copper and PGE, Oh my!

Chalice's Julimar mining project is located in the Avon Region of Western Australia with a project area slightly over 2,000km2 In size. To put that in visual terms, Julimar is approximately 16% the size of Sydney

(12,368km2). The mining project is still in its drilling stages and management has said it expects to complete a scoping study for the initial stages of project development to be completed in the first half of 2022.

The December 2021 quarterly activities report places Chalice's maiden Mineral Resource Estimate for the Gonneville section of Julmar at 330Mt @ 0.94g/t Pd+Pt+Au (3E), 0.16% Ni, 0.10% Cu, 0.016% Co. This may seem like plenty to justify all of the excitement surrounding Chalice, but management believes this is likely just the beginning. In fact, it has gone so far as to state "there are other mineralised intrusions in the area that have no EM response". In other words, the current discoveries are likely just the beginning.

Waiting on the scoping study

As we see it, there are only two catalysts that have the potential to drive Chalice's price even higher. The first is the coming scoping study. A scoping study lays out the initial estimates in detail, from the projected annual product to the Net Present Value (NPV). Once the scoping study is released to the market, investors will have a much easier time putting a value on the company. Still, despite all of the positive news out of Chalice and the current Mineral Resource Estimate for the Gonneville section, a lot of important information, like the initial costs, are still uncertain and the market tends to place uncertainty in the risk column. So, as long as there are no negative surprises, the release of the scoping study reduces the uncertainty around Chalice and should warrant a positive rerate of the stock.

The other catalyst that we believe has the potential to cause the stock to go higher is the potential for an increase in the current Mineral Resource Estimate for Gonneville.

Therefore, despite the massive gains shareholders have already booked, we are still fans of Chalice and believe that these two catalysts will likely emerge as positives for the company over the next year. Additionally, the company ended December 2021 well capitalised with approximately $65m in cash. In our view this means it is unlikely shareholders will need to be diluted anytime soon. So, while there is certainly risk at this valuation, we think it is worth it, four stars.

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Share price chart

Source: Tradingview

Look at what remains

A lot has changed since we last reported on Home Consortium in 2020. Simply put, Home Consortium divested two chunks of its property holdings into HomeCo Daily Needs REIT (ASX: HDN | see 27 November 2020 report) and HealthCo Healthcare and Wellness REIT (ASX: HCW). While Home Consortium no longer directly controls the properties, management kept them in the family as Home Consortium now manages the Real Estate Investment Trusts (REITs), for a fee of course.

However, don't think that Home Consortium got out of the property ownership game. The company still has $188m in investment properties (freehold) as of 30 June 2021. For those curious, freehold properties totalled $1bn as of 30 June 2020, but remember that this decline in value is nothing to worry about.

Before we dive into the remaining properties, it is important to note that while Home Consortium was given cash for the properties it transferred to the new REITs, the company also received an equity stake in the new trusts. Currently, Home Consortium controls 13.5% of HomeCo Daily Needs REIT and 20% of HealthCo Healthcare and Wellness REIT.

As of 30 June 2021, the adjusted freehold property portfolio (excluding all properties disposed of through spin-off REITs) consisted of eight properties with a Weight Average Lease Expiry (WALE) of 7.6 years, 99% occupancy and a strong Weighted Annual Capital Return (WACR) of 6.75%. Home Consortium's property portfolio is completely different from when we last reported on it, but one thing has stayed the same; its WALE is still the size of Moby Dick.

Management fees are here to stay

This leaves us with the Home Consortium's shiny and new management fees division. And when we say new, we mean brand new. Prior to FY21, this division did not exist in any form and, therefore, generated no revenue. In FY21, however, the division generated just over $10m.

But the question remains, just how significant were the mergers for the management fees division? As of the end of June 2021, total Assets Under Management (AUM) amounted to $2.5bn, growing 144% year-over-year.. However, by 2024, management expects to grow its AUM to over $10bn. In other words, AUM is forecasted to grow approximately 300% over the next three years.

While we don't have a step-by-step roadmap for how this growth will be achieved, we do know it will come from two sources: acquisitions and developments. However, both of these will be through HealthCo and HomeCo, not Home Consortium. As of FY21, HealthCo had a development pipeline greater than $500m, with a forecasted Internal Rate of Return (IRR) of 7%.

HomeCo has one that's considerably smaller at $130m, but its forecasted Return on Invested Capital (ROIC) is also 7%, enough to withstand the return of higher interest rates. When we combine these developments with pro forma liquidity of approximately $1bn as of the end of June 2021, the path to $10bn in AUM does not seem impossible. Still, it's a lofty goal and we will be sure to keep a close eye on management's progress.

Now fast enough growth

The current market consensus forecast has EBITDA growing 16% to $87m in FY23 and 21% to $106m in FY24. Based on these growth forecasts, FY23 and FY24's forecasted EV/EBITDA multiples are currently 24x and 20x, respectively. We do need to account for the $188m in property, meaning Home Consortium deserves a premium.

The stock had been on a tear, but has pulled back over the last few months. While the company's new "capital light" model clearly means we should not expect any major acquisitions from Home Consortium, it says nothing about the REITs it manages. Home Consortium's remaining properties have solid capital appreciation prospects. In fact, the properties jumped $225m in value in 1HY22. But we believe this has already been accounted for in the market's forecasts. Therefore, we believe that the market's EBITDA growth estimates are within reason and the company has a bit further to fall. Two stars.

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