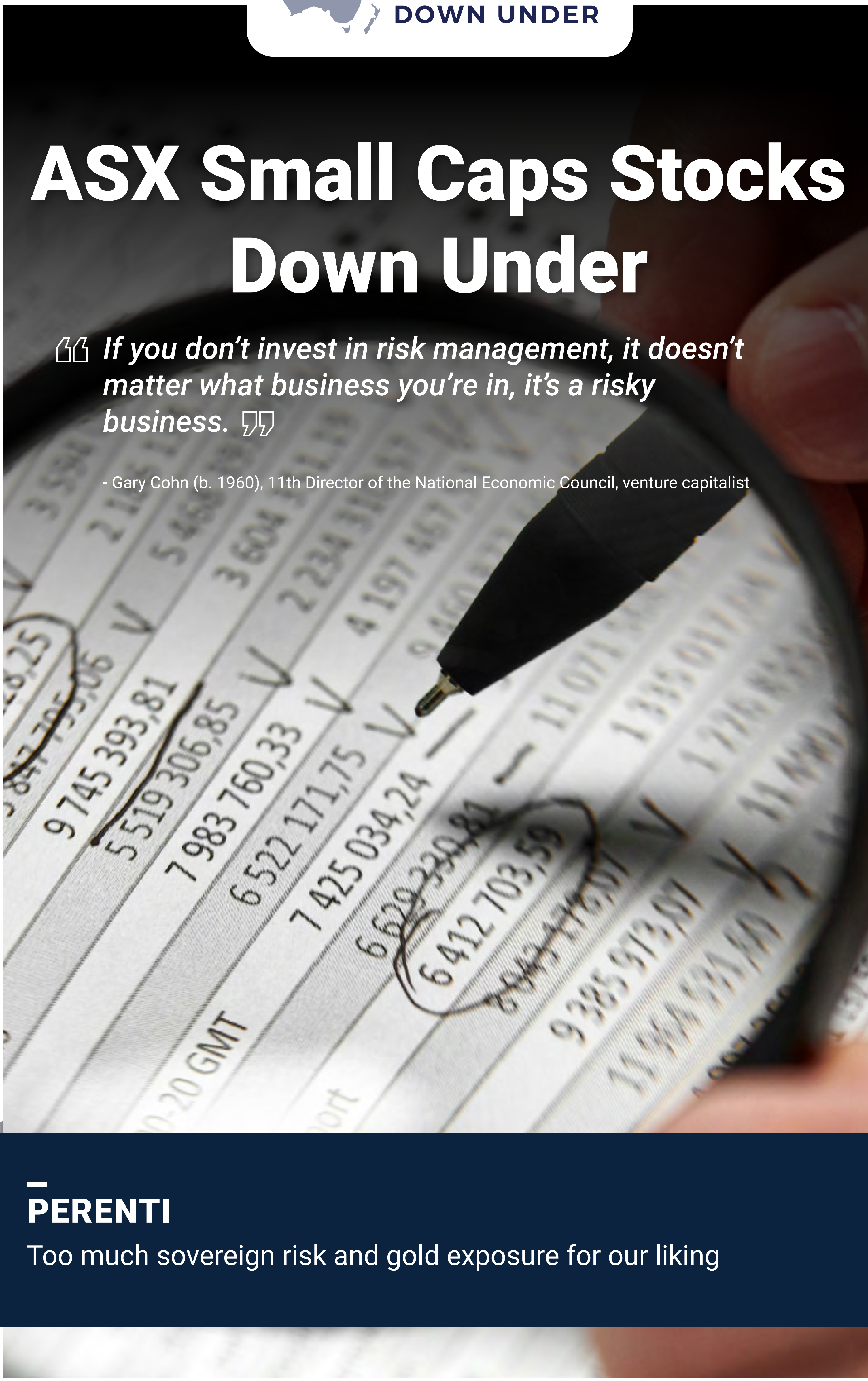
STOCKS DOWN UNDER

19 AUG 2022



ASX Small Caps Stocks Down Under

> *If you don't invest in risk management, it doesn't matter what business you're in, it's a risky business.*

- Gary Cohn (b. 1960), 11th Director of the National Economic Council, venture capitalist

PERENTI

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Stocks Down Under rating: ★★

ASX: PRN
Market cap: A$498.7M

52-week range: A$0.56 / A$1.05
Share price: A$0.71

It's been more than two years since we last covered mining services company Perenti (ASX: PRN). In April 2020, it had dropped from $2.36 less than six months earlier to $0.795, thanks to a number of hits, culminating in the Corona Crash. We said the stock was good buying at that time and you may think we were wrong given the share price is roughly 70 cents now, although the shares traded well over $1.00 in the twelve months after we published. Can Perenti bounce back again from where it is today? As recent history has shown, that will hinge on what happens in the jurisdictions it operates in and the gold price – neither of which we can have complete confidence in.

Share price chart

Source: Tradingview

Riding resources booms (and busts) when it can

In the good old days, mining companies did everything inhouse. But since the 1980s outsourcing has become an increasing popular option and this is where Perenti has come into the industry. Perenti offers surface and underground mining services including diamond drilling, design planning, equipment supply and maintenance. Across its subsidiaries, it employs over 8,000 staff and is present in over a dozen countries. Australia is one of them, where it services mines, including the KCGM Superpit, the Gruyere gold mine and the Nova-Bollinger mine. It also has a heavy presence in Africa, including in Burkina Faso, Egypt, Ghana and Mali.

Africa has been a double-edged sword for Perenti. On one hand, the company has benefited from increasing revenues and new work. On the other, it has posed sovereign risk challenges. One example was the 2019 Fada N'gourma attack in Burkina Faso. Perenti had been doing surface mining at the Boungou mine, but Islamic militant attacks killed 37 people and wounded a further 60. Around the same time, the company lost a contract in Ghana (with the Ghana Manganese Company) for no fault of its own. Why? Because the government had instructed GMC to cap its production at the mine, meaning Perenti's services were no longer required. This resulted in Perenti slashing its profit estimate from $140m to $115m-$120m. Incidents like these are not the company's fault and in no way reflect its performance. But, [as we observed when we last covered Perenti in April 2020](), incidents such as these can happen and can nonetheless have an impact.

Being in mining services, Perenti is also hostage to the boom-and-bust cycle of the resources space. Specifically, it is reliant on gold – 67% of its revenue comes from the precious metal. The gold price had a solid 2020 as the pandemic broke out given its reputation as a safe haven. But in 2021, gold was overshadowed both as an investment and demanded commodity. Investors turned to other metals and other investment options such as crypto. Meanwhile, miners turned their attention to battery metals given the rising popularity in EVs.

Supply chains and inflation are taking their toll. But will they ease?

Gold is not the whole story behind Perenti's decline. Perenti's EBITDA margins have been under pressure for over 18 months. Initially, it was travel restrictions and quarantine requirements that impeded the company's ability to do business in Africa. Although these have been phased out, Perenti has suffered from labour and supply chain issues as well as inflation.

Of course, no one is expecting these to last forever and Perenti certainly isn't. In May it told shareholders it would meet its revenue and earnings estimates - $2.4bn and $170m-$175m respectively. Consensus estimates for FY23 are $2.5bn revenue and $445.6m in EBITDA representing 3% and 6% growth respectively from FY22 consensus estimates. This is substantial growth from Perenti's guided earnings, but the company has excluded depreciation from its estimates. We note it is up 17% from the company's official EBITDA for FY21. If you expect these earnings will hold, you'll be paying 2.2x EV/EBITDA and 4.5x P/E for them. But of course, this is assuming no sovereign risk events occur and the price of gold does not fluctuate significantly. In FY25, Perenti hopes for a 20% Return on ROACE, a 10% EBIT margin and $2.5bn in revenue.

Is Perenti a buy?

We think ESG investors will not like this company because of the impact of mining on the environment, but also the risky work environment. Only 6 weeks ago, an incident occurred at one mine in Botswana that resulted in the death of two workers. The company says it is investigating, but ESG investors would arguably prefer that incidents like these never happened in the first place.

Short-term day traders might see this company as an opportunity. Looking technically, Perenti shares bottomed out at 57 cents in late July but is still some way below the $1 psychological level. The company recently unveiled plans for a share buyback program and has already bought back shares on market around 60 cents. But remember, this buyback will be at the expense of dividends.

On the other hand, we think longer-term investors may feel uncomfortable with the aforementioned risks, including sovereign risk, supply chain issues and Perenti's high exposure to gold. All of these are completely outside the company's control but could have a significant impact and render our analysis useless. We also don't see any potential catalysts with a significant chance of causing a substantial uptrend in the medium term. Consequently, for the latter group of investors, we think this one is two stars.

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