STOCKS DOWN UNDER

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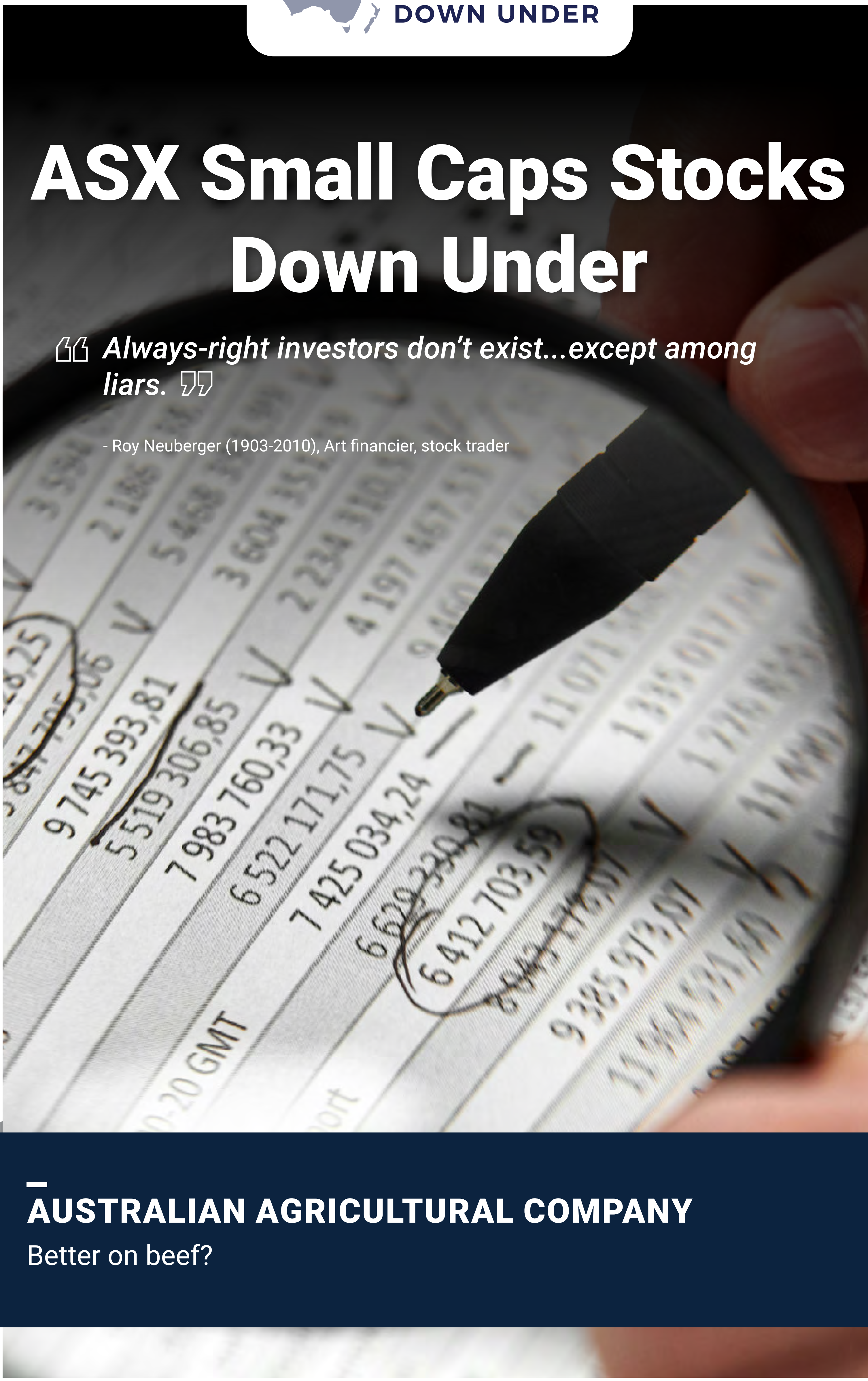
ASX Small Caps Stocks Down Under



> *Always-right investors don't exist...except among liars.*
>
> \- Roy Neuberger (1903-2010), Art financier, stock trader

AUSTRALIAN AGRICULTURAL COMPANY

Better on beef?

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Stocks Down Under rating: ★★★★

ASX: AAC
Market cap: A$1.1BN

52-week range: A$1.37 / A$2.40
Share price: A$1.90

Australian Agricultural Company (ASX:AAC) is a cattle grower owning roughly 1% of Australia's land mass across 6.4 million hectares in Queensland and the Northern Territory. From an operational perspective, right now is a good time to be a cattle grower with solid agricultural conditions and underlying demand for beef. But the company recently saw the departure of its CEO.

Share price chart

Source: Tradingview

Nearly two centuries of operation

AAC has only been listed since 2001, but traces its origins back to 1824, making it one of Australia's oldest companies. AAC has been through several booms, busts and even the occasional disaster in its history. It once specialised in lamb as well, but now it is purely focused on beef, particularly Wagyu beef, which is a high-end and premium offering. AAC feeds over 1m people throughout the world every day.

AAC's business model is simple - rearing cattle until they are ideal to be sent to abattoirs. AAC's cattle is sold domestically and all over the world – in Asia, North America, Europe and the Middle East. Asia is the most important market with 52% of total meat sales. If you exclude China, this drops to 42%, but is still well ahead of the next biggest market (North America) at 26%. Its beef is sold under 3 brands: Wylarah, Westholme and Darling Downs.

Closing Livingstone Valley pays off

AAC has a processing facility of its own at Livingstone Valley in the NT, that it opened with much fanfare in 2015, with then PM Tony Abbott personally opening it. However, the facility has been held in a suspended state since 2018 due to underperformance – leaving it reliant on external parties. At the time this caused controversy given write-downs and jobs put into limbo, but arguably this was for the best.

Since February 2019, the company's share price has roughly doubled. And in FY22, the 12 months to 31 March 2022, it made a $136.9m statutory profit (up from $45.4m in FY21). Admittedly, this includes an unrealised $129.6m gain on the value of its herd, but its underlying basis grew from $24.4m to $49.9m. Its cost of production decreased 6% due to tight operational controls and a focus on supply chain efficiencies. And even though wagyu kilograms sold was 14% lower, the average price per kilo grew 21% given the rise in the price of beef. AAC's Net Tangible Assets (NTA) grew 30% to $2.27 per share, placing it at an 18% discount to the current share price. And FY22 marked the fourth straight year of positive operating cash flow.

Other operational metrics have significantly improved, for instance the company's operating profit margin, which was –3.6% in FY18 and expanded to 18.1% now, although it did dip in FY20. Its balance sheet boasts $1.17bn in pastoral property and $736.2m in livestock. It has $600m in total syndicated borrowing capacity and $231m in undrawn debt capacity although only $9.3m in cash. It boasts a handful of prominent substantial shareholders, including Andrew 'Twiggy' Forrest - who has gradually built up a 5% stake since late 2019; Paul Holmes à Court (who owns 7%) and Tavistock, which owns a whopping 48%. The latter is the investment vehicle of billionaire and Tottenham Hotspur owner Joe Lewis.

A record of growth, but not the greatest diversity

Having survived nearly two centuries, you could argue Australian Agricultural Company is one of the safest investments on the ASX. But its share price fluctuations depict that not all times are good times to buy in and, ultimately, we don't think now is the right moment given the following four reasons.

The first is that it has not paid a dividend since before the GFC. It's one thing if it never had in the first place, but the company has never resumed dividend payments despite having promised to do so before. In 2019, it told shareholders it would re-start once things were working well and debt was under control. Ever since, it has been blaming the uncertain environment despite its strong performance and returning directors' fees to pre-COVID levels. To investors wanting growth rather than dividends this may not matter, but we think it says something about management.

The second is the recent departure of CEO Hugh Killen, which occurred without notice or reason and was a shock to shareholders. AAC is looking for a replacement and will no doubt find one, but investors may want to see who takes the hot seat and how long it takes to fill it. They also might want to see the new CEO's remuneration – Killen's pay was ~$1m, including a $270,000 bonus.

The third reason for our caution is the stocks high multiples at 29.3x EV/EBITDA and a whopping 104x P/E for FY23. This is high enough before you consider consensus estimates predict a big drop in EBITDA from over $228m in FY22 to just $52m in FY23. You could argue some of this drop is simply because of anticipation that property valuations won't go up excessively, if at all. Revenues are forecast for 6% growth – from $276m to $293m.

Fourth is that Australian Agricultural Company will likely not appeal to ESG investors. Obviously ESG investors typically dislike farming, given methane emissions and animal slaughter. But we also note, it has only had one female director in its history, Jessica Rudd. It has promised to have 30% women on its board by 2024, but we doubt that is good enough for ESG investors.

So, we think it's two stars for now, but observe that non-ESG investors might find this stock appealing if and when it starts paying dividends again and finds a new CEO.

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