



Avarga Limited

(AVARGA SP/AVAR.SI)

Laggard COVID-19 play

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- The V-shape recovery in the housing market in Canada and US has been driven by people moving away from cities, and towards suburban areas.
- Lumber in North America is trading at an all-time high owing to growing demand and disrupted supply.
- Avarga's main business contributor, Taiga building Products (70.8% ownership), runs a business of lumber and other building materials distribution, benefiting from the high lumber prices.
- We do not have an official rating but estimate a fair value of S\$0.43 based on 10x FY2020F P/E. Earnings this year will largely be driven by Taiga's 2H20 performance. Potential further upside if it is able to monetise its two other businesses in Asia, which we have not included in our fair value estimates.

Housing market bonanza. In the current recession, most savings and investments are not hit as badly as during the global financial crisis. Work from home, low interest rates, and government aid have favoured the housing market as people move out of major cities to avoid infections.

Lumber going through the roof. Lumber prices have skyrocketed due to supply shortage and strong demand. Inventory level of lumber is declining rapidly while quite a few sawmills have yet to resume operations in Canada.

Jackpot for Taiga. The increase in lumber price gives Taiga the ability to charge a higher mark-up on products, as well as earn extra gross profits from earlier inventory that was stocked at lower prices.

Valuation & Action:

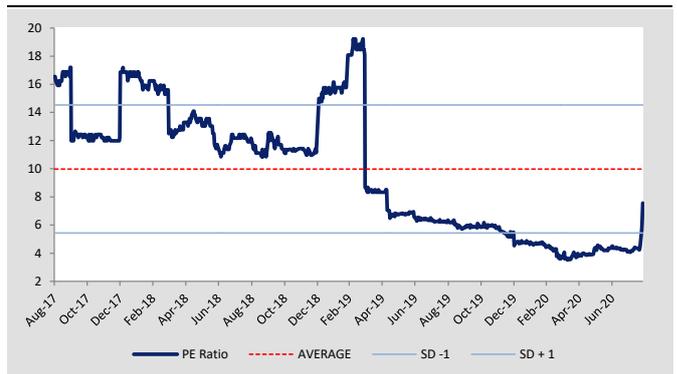
We think a fair value of S\$0.43 is the minimum for Avarga. We utilise a 10x FY2020F P/E, which is based on the 3-year historical average of Avarga. Avarga's crown jewel is its 70.8%-owned Canadian-listed building material distribution company - Taiga Building Products (TBL CN).

We forecast Taiga's 3Q20 earnings to jump 78% QoQ as it benefits from higher lumber prices and strong demand, but conservatively estimate that 4Q20 will drop 44% QoQ on the back of a seasonally weak 4Q. As a result, we estimate profits after minority interest of at least S\$41mn for Avarga in FY2020F.

Our fair value does not include the value of Avarga's two other businesses (paper manufacturing and power plant in Myanmar), and hence we believe that our valuation is on the conservative side

Not Rated		Performance (Absolute)	
Price as of 25 Aug 20 (SGD)	0.22	1 Month (%)	63.8
12M TP (\$)	0.43	3 Month (%)	69.9
Previous TP (\$)	-	12 Month (%)	33.8
Upside, incl div (%)	101.0		
Trading data		Perf. vs STI Index (Red)	
Mkt Cap (\$mn)	222		
Issued Shares (mn)	947		
Vol - 3M Daily avg (mn)	1.8		
Val - 3M Daily avg (\$mn)	0.3		
Free Float (%)	45.2%		
Major Shareholders		Previous Recommendations	
Tong Kooi Ong	31.2%		
Peter Lim	19.4%		

Figure 1: 3-year historical P/E multiple (Avarga). We used 3 years as Avarga only acquired Taiga in 2017, and increased its stake to become the major shareholder in 1Q2018.



Source: Bloomberg, KGI Research

Figure 2: Valuation of Avarga, factoring only its North American business (excluding paper manufacturing and power plant in Myanmar)

Profits Quarterly forecast (Taiga only)	Remarks
1Q20 (CAD\$) mn	6.60
2Q20 (CAD\$) mn	13.00 Lumber prices started to rise significantly from end-June 2020
3Q20 (CAD\$) mn	23.17 Weighted average based on increase in lumber prices
4Q20 (CAD\$) mn	13.00 Lumber prices to correct back
FY2020F Earnings (CAD\$) mn	55.77
CAD/SGD	1.04
FY2020 Earnings (SGD) mn	57.78
70.78% share to Avarga (SGD) mn	40.90 Avarga owns 70.78% of Taiga
PE Multiple	10.0 Avarga's 3-year historical average P/E
Fair value (SGD) mn	409.00
Shares outstanding	946.50 Avarga shares outstanding
Price target (SGD)	50.43
Current price (SGD)	0.215
Upside (%)	101%

Source: Bloomberg, KGI Research

Risks:

The performance of Taiga depends on the demand for building materials and lumber price. In the short term, the sawmills could speed up the resumption of operation to capture the high selling price of lumber. The housing demand could taper when COVID-19 is completely contained, and work from office is back to pre-COVID period.

Investment thesis

V-shape recovery in housing market in Canada and US

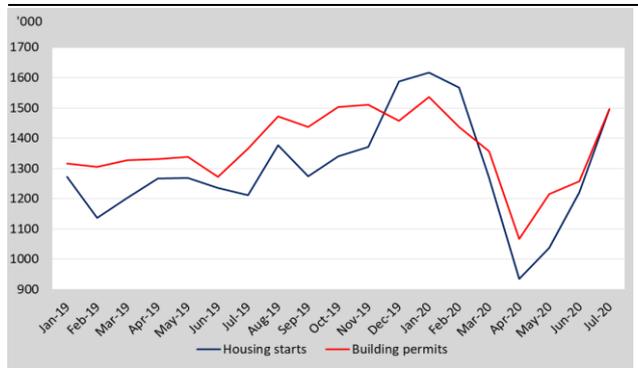
North America, especially the US, is far from containing the COVID-19 pandemic even though it has been five months since the outbreak occurred. However, the housing market performed strongly and showed resiliency, which is counter-intuitive. Logically, housing market should be hit severely because people will have a tendency to be thrifty during an economic downturn, and the spending on big ticket items will substantially decline accordingly. However, this time seems to be different. Unlike GFC in 2008 that wiped out significant amount of savings and investments, the current recession as a result of the pandemic has not squeezed liquidity since central banks reacted immediately. The main reason the housing market rebounded quickly is because people moved away from big cities to suburban areas. The prevailing working from home environment has enabled workers to detach from their work places. Other beneficial factors like the low interest rate, and government subsidies and aids, have also helped the housing boom in North America.

Figure 3: Housing construction in Canada (seasonally adjusted)



Source: Bloomberg, KGI Research

Figure 4: Housing construction in US (seasonally adjusted)

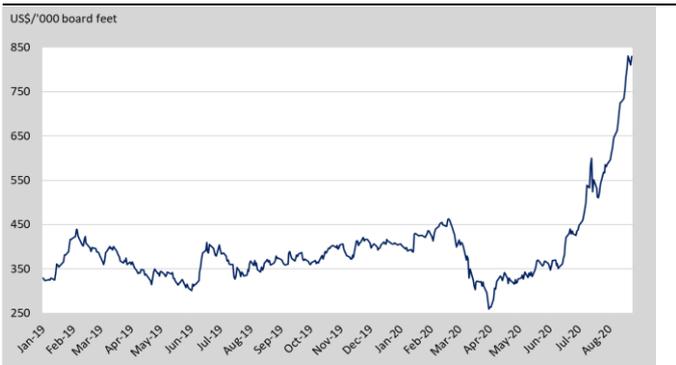


Source: Bloomberg, KGI Research

Lumber is trading at an all-time high

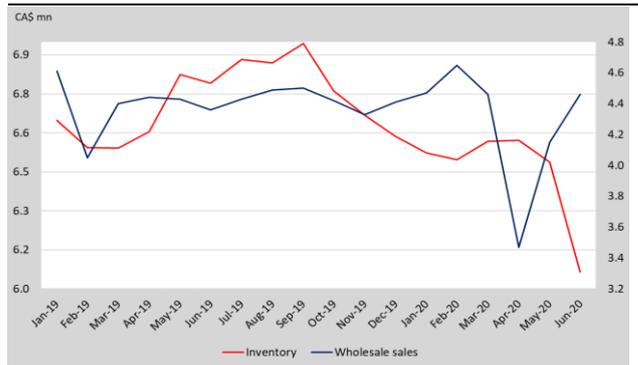
Lumber is one of the hottest commodities now. The return YTD is more than 100% as of 25th August. After June 2020, the price started to take off. Such an exponential growth in a few months' time is attributable to the mismatch between supply and demand. Lumber market is facing shortage of supply because of shut-down of sawmills that treat the wood due to COVID-19 restriction of labour density in Canada. Meanwhile, the home building demand is picking up rapidly at the moment. The inventories of building materials, especially lumber has been substantially declining since April while the wholesale sales presented a V-shape rebound. What is happening in the lumber market in Canada now is similar to the meltblown fabric (main materials used in mask production) market in February and March in China when demand for masks surged and supplies failed to catch up.

Figure 5: Exploding lumber price



Source: Bloomberg, KGI Research

Figure 6: Lumber, millwork, hardware, and other building supplies



Source: Bloomberg, KGI Research

Main business driver analysis of Taiga

Taiga has two major business drivers – housing starts (in relation to sales volume) and the price of lumber (in relation to product pricing). Taiga expects the sale volume of its products to remain fairly stable over the years, and price movements in lumber to have a greater, but short-term impact on its financial performance. The increase of lumber price gives Taiga the ability to charge a higher mark-up on products, as well as earn extra gross profit from earlier inventory that was stocked at lower prices. This was illustrated in 2019's results where Taiga's revenue was –11.2% YoY from a lukewarm Canadian housing market, yet gross margins increased by 1.6ppt from 8.4% to 10%, and PBT margins increased 0.76 ppt to 2.45% as a result of steady price increment of lumber throughout the year.

However, the price of lumber itself is influenced by housing starts, as well as lumber inventory. The recent lumber futures boom, and subsequent price rise of lumber, is influenced by both factors. Firstly, the homebuilding sector was expected to sour due to COVID-19, but saw a strong recovery post-lockdown. [Insert June/July 2020 figures]. Secondly, a number of sawmills and treatment plants were shut down during COVID-19, reducing processing capacity, leading to a miss-match between rising demand and dwindling supply of processed lumber.

While lumber prices will eventually correct as supply is restored, we see this as a short-term boon for Taiga, who will experience substantial inventory gains on its S\$130mn+ of inventory as of June 2020. Taiga can also charge a higher mark-up on their goods as lumber is now largely a sellers' market. 2Q20 results have already displayed such a tendency as Taiga's gross margins rose to 12%.

Avarga Valuation

Minimum fair value of S\$0.43 for Avarga. We think a fair value of S\$0.43 is the minimum for Avarga. We utilise a 10x PE multiple, which is based on the 3-year historical average of Avarga. Avarga's crown jewel is its 70.8%-owned Canadian-listed building material distribution company - Taiga Building Products. We forecast Taiga's 3Q20 earnings to jump 78% QoQ as it benefits from higher lumber prices and strong demand, but conservatively estimate that 4Q20 will drop 44% QoQ on the back of a seasonal weak 4Q. As a result, we estimate profits after minority interest of at least S\$41mn for Avarga in FY2020F.

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Figure 7: Forecast and valuation

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Quantitative analysis

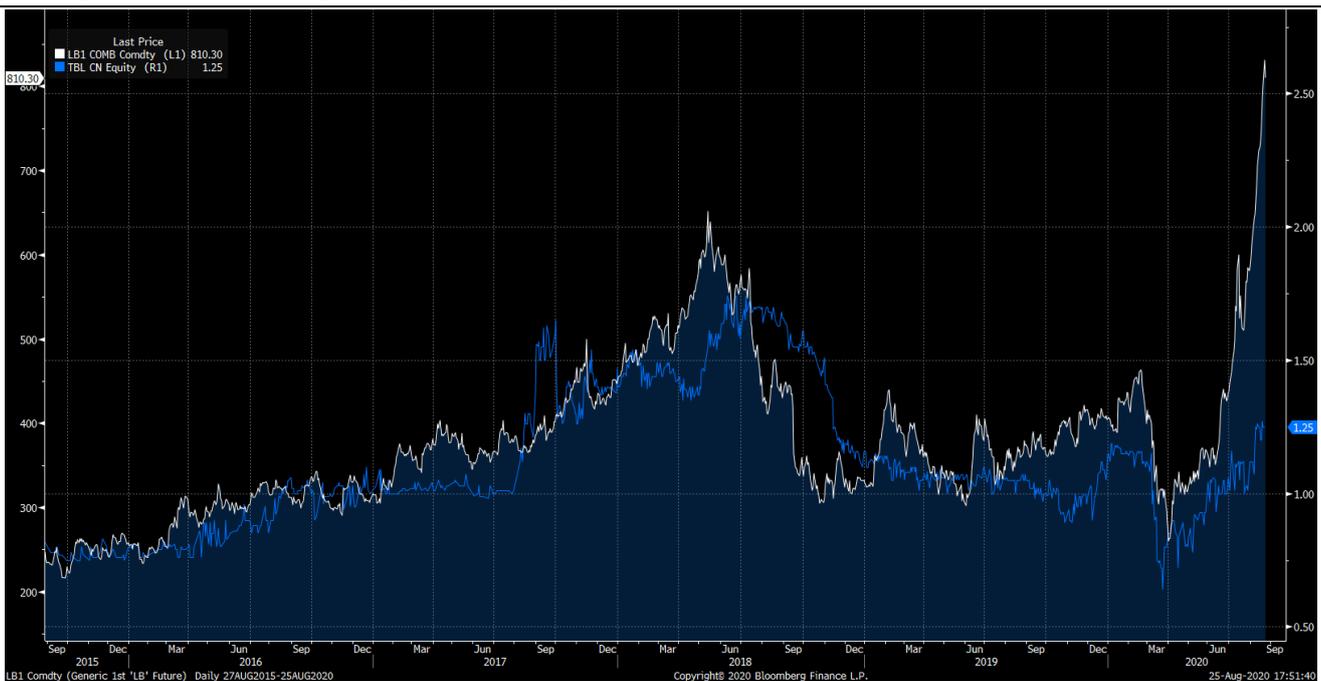
Taiga’s share price correlates highly with lumber prices over the last five years. Based on a regression analysis of Taiga’s share price and lumber prices (monthly change with a 2 months lag for Taiga’s share price), we derive a correlation of 0.82. Based on this analysis (see regression graph below; $Y=0.003X + 0.18$), Taiga’s share price should at least double if we are to factor in the 100% rise in lumber prices since June 2020. This fits well with our earnings forecast for Taiga in FY2020F and a 10x earnings multiple.

Figure 8: Regression analysis of lumber prices and Taiga’s share price (5 years regression)



Source: Bloomberg

Figure 9: High correlation between Taiga’ share price and lumber price

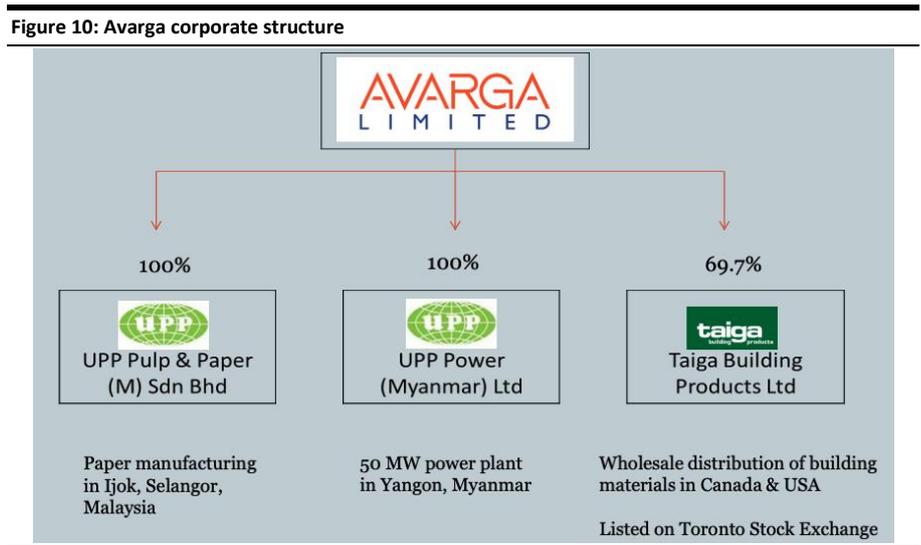


Source: Bloomberg

Company background

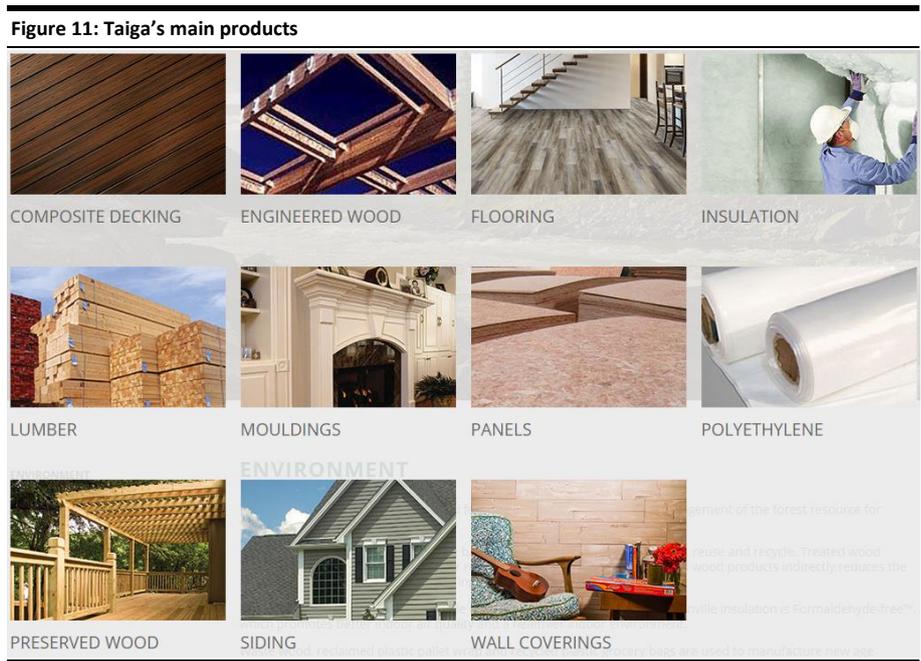
Company snapshot. Avarga Limited, formerly known as UPP Holdings Limited, is an investment holding company, listed on the main board of Singapore Exchanged Limited. The company is engaged in three segments of business, namely building materials distribution, paper manufacturing, and power generation with a global footprint across five countries and 30 location sites.

Business segments. The three segments of business are operated by respective the subsidiaries shown below.



Source: Company

Taiga building products is a leading independent wholesale distributor of building materials. Taiga produces preserved lumber at three plants located to service the Canadian market. It has 15 distribution centres in Canada, 3 distribution centres in the Western US and 6 reload stations in Eastern US. In addition, Taiga exports products into markets in Asia, Central and South America, and the Middle East. It owns Exterior Wood, Inc which is located in Washougal, Washington, and services thirteen western states with high-quality treated lumber.

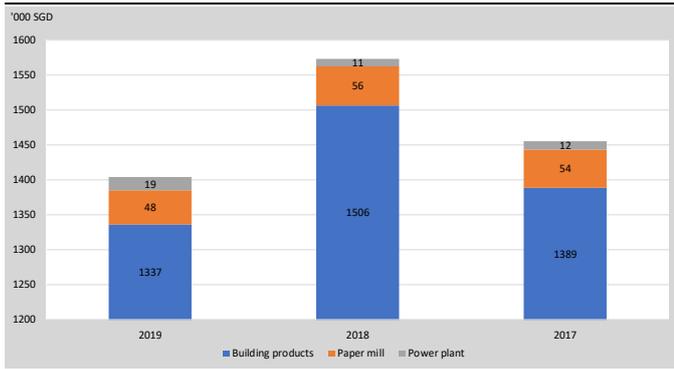


Source: Company

UUP Pulp & Paper (M) is one of the top 5 paper mills in Malaysia, accounting for 10% of the domestic production of brown packaging paper (industrial grade) which are mainly used for corrugated carton boxes and other finished paper products.

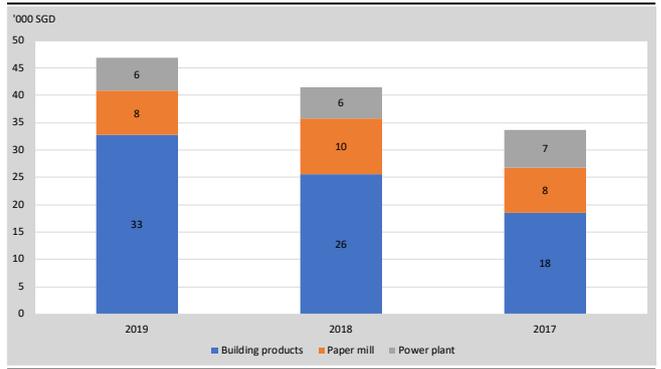
UUP Power (Myanmar) is one of Myanmar’s first foreign-owned independent power suppliers, accounting for 2% of the domestic power supply. The 50 MW gas-fired plant commenced operation in 2014 and is contracted to provide at least 350mn kWh per annum with a concession period of 30 years.

Figure 12: Revenue breakdown



Source: Company

Figure 13: PBT breakdown



Source: Company

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Rating	Definition
Outperform (OP)	We take a positive view on the stock. The stock is expected to outperform the expected total return of the KGI coverage universe in the related market over a 12-month investment horizon.
Neutral (N)	We take a neutral view on the stock. The stock is expected to perform in line with the expected total return of the KGI coverage universe in the related market over a 12-month investment horizon.
Underperform (U)	We take a negative view on the stock. The stock is expected to underperform the expected total return of the KGI coverage universe in the related market over a 12-month investment horizon
Not Rated (NR)	The stock is not rated by KGI Securities.
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