Drilling Down

Investing in drilling-services companies, let alone newly public, small-cap Australian ones, could be considered a potentially harrowing experience. Matthew Haynes explains why he expects that not to be the case with DDH1.

Oversimplifying, there are three big questions a value investor has to answer when investing in a commodity-related business like Australia's DDH1 Ltd. Are we at an attractive point in the relevant commodity cycle? How resilient are the financials if the cycle turns the wrong way? How cheap is the stock relative to conservatively estimated prospects?

Sprott Asset Management's Matthew Haynes believes DDH1 passes that simple test with flying colors. The company provides third-party drilling services, specializing in multi-disectional directional drilling, used to reach deeper and harder-to-access deposits of gold and other metals. In its latest fiscal year, 60% of revenues came from gold, 18% from iron ore and most of the rest from copper and nickel. The company was founded in 2006, took on Oaktree Capital as a then-50% owner in 2017, and sold shares to the public in March of this year.

While commodity prices almost across the board have been rising, Haynes argues the outlook remains positive for many of the metals for which DDH1 equipment drills. Gold companies have struggled to replace reserves net of production for the past decade, implying heavy pent-up demand for gold drilling that is already evident. He expects demand for copper and so-called platinum group metals to outstrip supply for years to come, driven by broadly increasing electrification and digitization, prominently evidenced in electric vehicles. Capital markets of late have been generous to exploration-stage mining companies, raising money that he expects to go almost "directly into the drill rig."

He sees many factors setting DDH1 apart when it comes to resilience. Its customer base consists primarily of large-scale, low-cost miners with an ongoing need to replenish reserves at mature mines regardless of the cycle stage. Its deep-drilling programs are often longer-term in nature and require a higher degree of expertise, enhancing profitability through the cycle. Its equipment is flexible and all in Australia, minimizing mobilization costs and underutilization of rigs. Management also has an excellent record in managing costs and runs a net-cash balance sheet, ensuring sufficient capital even for reinvestment through down cycles. The proof so far is in the pudding: since 2006 the company has never had an unprofitable year.

How cheap are the shares, now at A$1.15? Assuming 15% revenue growth, stable EBITDA margins of 25% and $26 million in depreciation expense, Haynes estimates DDH1's operating income for the year ending next June at A$55 million. That results in a forward EV/EBIT multiple today of just 7.2x, half the valuation accorded Canadian peer Major Drilling [Toronto: MDI]. At what he considers a fair 12x multiple, the stock would trade at around A$2. "We actually own Major Drilling as well, but DDH1 is a materially superior company," he says. "We don't believe that valuation discrepancy will persist as the drilling upcycle progresses." VII

INVESTMENT SNAPSHOT

DDH1 Ltd.
(Sydney: DDH)

Business: Australia-based provider of drilling services; commodity exposure in its latest fiscal year was 60% gold and 18% iron ore.

Share Information
(@6/29/21, Exchange Rate: $1 = A$1.33):

Price	**A$1.15**
52-Week Range	A$0.81 – A$1.18
Dividend Yield	0.0%
Market Cap	A$397.6 million

Financials (FY2020):

Revenue	A$249.8 million
Operating Profit Margin	17.1%
Net Profit Margin	10.5%

Valuation Metrics
(@6/29/21):

	DDH	S&P 500
P/E (TTM)	16.0	37.3
Forward P/E (Est.)	11.7	22.5

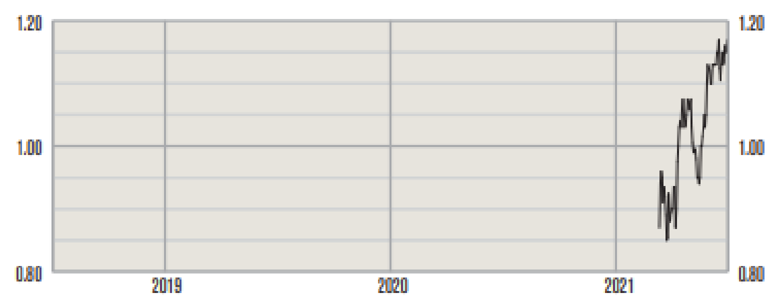
Largest Institutional Owners
(@3/31/21 or latest filing):

Company	% Owned
Oaktree Capital	22.1%
Tribeca Inv Partners	6.1%
Wilson Asset Mgmt	5.3%

Short Interest (as of 6/15/20):

Shares Short/Float	n/a

DDH PRICE HISTORY



THE BOTTOM LINE

With cyclical tailwinds and a highly resilient business model, the company's prospects are far brighter than the market appears to recognize, says Matthew Haynes. Applying a 12x EV/EBIT multiple to his FY2022 estimates, the shares would trade at around A$2.

Sources: Company reports, other publicly available information