

21 July 2023

## Managing what can be managed

### NEED TO KNOW

- Incremental improvements drive market share and long term margins
- Strong cash position with surplus capital from lower average magnesium prices
- Expectations of reduced magnesium capacity and higher long-term prices remain unrealised. Near term, earnings to follow weaker magnesium prices.

MGL continues to make incremental improvements in its Anodes business – the main driver of sustainable earnings. It is growing share, expanding in the US and driving growth in electronic anodes. Similarly, in the strategically valuable scrap business it is processing low grade waste.

The Group has a strong cash position with surplus capital released from lower working capital reductions due to the lower magnesium price.

Our forecasts are based on spot rates for magnesium – the most important earnings driver for the Group. Notwithstanding ongoing announcements about capacity reductions in China, higher magnesium prices are yet to be realised. Our expectation of near-term earnings weakness is consistent with guidance commentary.

### Investment Thesis

MGL showed supercharged earnings in CY22 across the three magnesium processing businesses in China and Europe. Buoyed by the strong magnesium price, Magontec managed its strong position in both the Anodes and the Recycling industries to maximum benefit.

The Anodes business has shown stable earnings and high market share in the niche sector. It has been valued separately based on comparable companies' average EV/EBITDA multiples, discounted by 30%.

The timing of the Qinghai plant's restart is uncertain into CY24, but if the plant achieves just 50% of capacity utilization at current levels, we add \$0.45 per share.

### Valuation

We value Magontec on a sum-of-the-parts basis. The relatively stable and growing Anodes business is valued on an earnings multiple, Metals (recycling) on a capacity multiple based on historic transaction multiples, and the Qinghai alloy plant contribution is a heavily discounted valuation of prospective earnings – we currently attribute \$0.06 per share for the restart of Qinghai alloy production in CY24. The decline in forecast earnings from Anodes has been broadly offset by an increase in comparable company multiples. If Qinghai were to achieve 50% capacity utilization of Qinghai, our valuation would increase to \$1.00.

### Risks

Risks include the failure of the Qinghai cast house to receive the planned magnesium metal, and the breach of agreements by QSLM. A deteriorating competitive environment and a potential loss of access to capital add to the risks.

### Equities Research Australia

#### Industrials

**Andrew Johnston**, Senior Analyst  
andrew.johnston@mstaccess.com.au

**Noah Hunt**, Associate Analyst  
noah.hunt@mstaccess.com.au



Founded in 1953, MGL's operations involve the manufacture of magnesium anodes for corrosion protection in water heaters, and manufacture and recycling of magnesium alloys that are sold into the global auto industry. The Company has manufacturing facilities in Europe and China and sales in those regions, as well as the US. Its primary alloy production facility in Qinghai, China is operating at a loss, awaiting the restart of its magnesium supplier. Once restarted, MGL will be one of the few suppliers of low-CO2 magnesium alloys.

<http://magontec.com/>

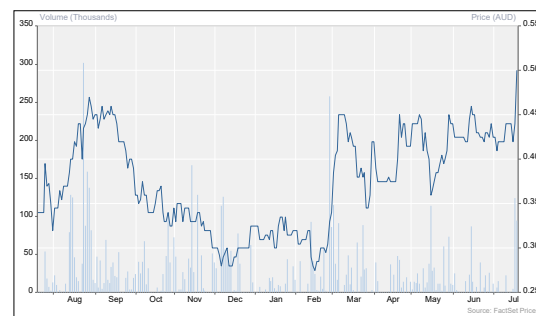
Valuation	<b>A\$0.62</b> (previously A\$0.56)
Current price	<b>A\$0.52</b>
Market cap	<b>A\$40m</b>
Cash on hand	<b>A\$11.3m</b>

### Upcoming Catalysts and News flow

**HY23 Result**

Aug 2023

### Share Price (A\$)



Source: FactSet, MST Access

# Financial Summary

Magontec Limited (MGL-AU)

Year End 31 Dec	2020A	2021A	2022A	2023E	2024E	2025E	Stock information			
Core PE	x	nm	9.3x	2.7x	8.7x	11.4x	6.3x	Share Price	\$	0.52
EV/EBIT	x	144.1x	6.5x	1.6x	3.1x	2.0x	1.2x	Market capitalisation	\$m	40.3
<b>EV/EBITDA</b>	<b>x</b>	<b>14.9x</b>	<b>4.6x</b>	<b>1.4x</b>	<b>2.2x</b>	<b>1.2x</b>	<b>0.9x</b>	<b>Valuation</b>	<b>\$</b>	<b>0.62</b>
Div yield	%	0.0%	0.0%	2.3%	2.3%	2.3%	2.3%	Shares on issue (Basic)	m	77.5
FCF Yield	%	nm	12.4%	22.0%	42.5%	32.1%	3.8%	Shares on issue (diluted) (m)	m	84.6

Profit & Loss Statement	\$m	2020A	2021A	2022A	2023E	2024E	2025E	1H CY21	2H CY21	1H CY22	2H CY22	1H CY23E	2H CY23E
<b>Revenue</b>		<b>95.1</b>	<b>115.2</b>	<b>158.6</b>	<b>106.3</b>	<b>127.4</b>	<b>164.4</b>	<b>50.9</b>	<b>64.3</b>	<b>93.8</b>	<b>64.8</b>	<b>54.1</b>	<b>73.3</b>
<i>Change pcp</i>	%		<i>21.1%</i>	<i>37.7%</i>	<i>-33.0%</i>	<i>19.9%</i>	<i>29.0%</i>			<i>84.4%</i>	<i>0.8%</i>	<i>-42.3%</i>	<i>13.1%</i>
<b>Gross Profit</b>		<b>12.2</b>	<b>19.2</b>	<b>38.6</b>	<b>20.5</b>	<b>19.0</b>	<b>22.5</b>	<b>7.7</b>	<b>11.5</b>	<b>26.8</b>	<b>11.8</b>	<b>8.6</b>	<b>10.4</b>
margin	%	12.8%	16.7%	24.3%	19.2%	14.9%	13.7%	15.1%	17.9%	28.5%	18.3%	15.9%	14.2%
<b>EBITDA</b>		<b>3.5</b>	<b>10.1</b>	<b>27.3</b>	<b>10.2</b>	<b>8.6</b>	<b>11.8</b>	<b>3.4</b>	<b>6.7</b>	<b>21.3</b>	<b>6.0</b>	<b>6.8</b>	<b>1.8</b>
margin	%	3.7%	8.8%	17.2%	9.6%	6.7%	7.1%	6.6%	10.4%	22.7%	9.3%	12.6%	2.4%
Depreciation and Amort		-3.1	-2.8	-2.8	-3.1	-3.3	-3.5						
EBIT		0.4	7.3	24.5	7.1	5.3	8.3						
Finance expense		-0.6	-0.5	-0.7	-0.4	-0.1	0.0						
Tax and adjustments		-0.5	-1.7	-7.3	-1.7	-1.3	-2.1						
<b>NPAT (reported)</b>		<b>-0.7</b>	<b>5.0</b>	<b>16.5</b>	<b>5.1</b>	<b>3.9</b>	<b>6.2</b>						
Significant, discontinued et.al		-0.4	0.6	0.0	0.0	0.0	1.0						
<b>NPAT (Underlying)</b>		<b>-0.3</b>	<b>4.4</b>	<b>16.5</b>	<b>5.1</b>	<b>3.9</b>	<b>7.2</b>						

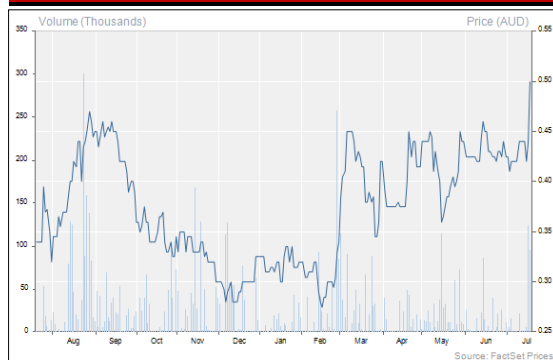
Per Share Data	2020A	2021A	2022A	2023E	2024E	2025E	Segments				
Ave. diluted shares outstanding	m	76	79	85	85	86	87				
<b>Underlying EPS</b>	<b>cps</b>	<b>-0.4</b>	<b>5.6</b>	<b>19.5</b>	<b>6.0</b>	<b>4.5</b>	<b>8.3</b>				
growth pcp	%		nm	250%	-69%	-24%	82%				
Reported EPS	cps	-0.9	6.3	19.5	6.0	4.5	7.1				
growth pcp	%		nm	209%	-69%	-24%	57%				
DPS	cps	0.0	0.0	0.2	0.7	0.7	0.7				
Payout (on underlying)	%	0%	0%	1%	12%	16%	9%				

Balance sheet	\$m	2020A	2021A	2022A	2023E	2024E	2025E	Segments			
Cash & Deposits		5	5	11	20	32	31				
Receivables		22	21	25	23	23	27				
Inventory		22	24	36	26	27	35				
PP&E (incl right of use assets)		19	18	17	15	13	10				
Intangibles		3	3	3	3	3	3				
Other Assets		3	12	4	2	2	2				
<b>Total Assets</b>		<b>75</b>	<b>83</b>	<b>96</b>	<b>90</b>	<b>99</b>	<b>108</b>				
Payables		13	18	12	11	18	23				
Borrowings		17	12	9	2	1	0				
Provisions / other (incl. Lease Liab.)		17	17	19	19	19	19				
<b>Total Liabilities</b>		<b>46</b>	<b>46</b>	<b>40</b>	<b>31</b>	<b>38</b>	<b>42</b>				
<b>Shareholders' Funds</b>		<b>29</b>	<b>36</b>	<b>56</b>	<b>58</b>	<b>61</b>	<b>66</b>				
<b>Net Debt</b>		<b>12</b>	<b>7</b>	<b>-2</b>	<b>-18</b>	<b>-31</b>	<b>-31</b>				

Cashflow statement	\$m	2020A	2021A	2022A	2023E	2024E	2025E	Share price and volume			
EBITDA		0.0	10.1	27.3	10.2	8.6	11.8				
Net interest		0.0	-0.5	-0.6	-0.4	-0.1	0.0				
Tax paid		0.0	-0.5	-2.3	-1.7	-1.3	-2.1				
Working capital movements		0.0	-3.6	-14.4	10.1	7.0	-7.1				
Other		0.0	0.0	0.0	0.0	0.0	0.0				
<b>Operating CF</b>		<b>0.0</b>	<b>5.4</b>	<b>10.0</b>	<b>18.3</b>	<b>14.2</b>	<b>2.6</b>				
Capital expenditure		-0.7	-0.9	-1.9	-1.0	-1.0	-1.0				
Asset sales		0.0	0.0	0.0	0.0	0.0	0.0				
Acquisitions		0.0	0.0	0.0	0.0	0.0	0.0				
Other		-0.4	0.0	0.1	0.0	0.0	0.0				
<b>Investing CF</b>		<b>-1.1</b>	<b>-0.8</b>	<b>-1.8</b>	<b>-1.0</b>	<b>-1.0</b>	<b>-1.0</b>				
Net borrowings		-2.8	-5.3	-1.9	-7.3	-0.8	-1.2				
Dividends paid		0.0	0.0	-0.2	-0.6	-0.6	-0.6				
New share issues		0.0	0.0	0.0	0.0	0.0	0.0				
<b>Financing CF</b>		<b>-2.8</b>	<b>-5.7</b>	<b>-2.4</b>	<b>-8.1</b>	<b>-1.7</b>	<b>-2.1</b>				
<b>Net change in cash</b>		<b>-3.9</b>	<b>-0.7</b>	<b>6.6</b>	<b>9.2</b>	<b>11.5</b>	<b>-0.5</b>				

Note: Right of use assets = ~3% of PP&E

Source: Company, MST Access



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## Operational improvements

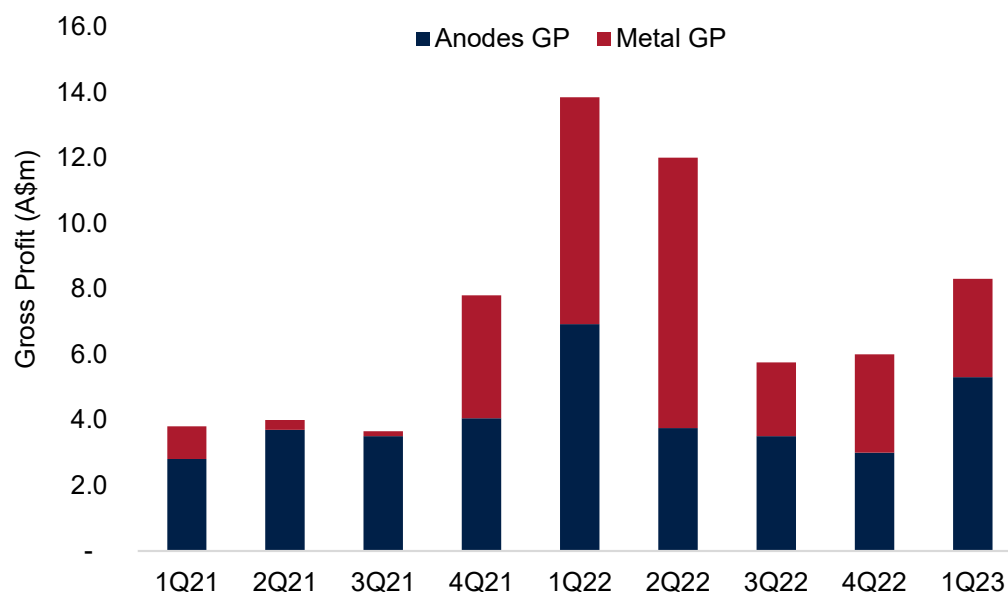
Magontec continues to make incremental improvements across its business units. These improvements are resulting in higher market shares in the anodes business, strong growth in the higher margin, electronic anodes business, and regulatory tailwinds in new markets.

The most important near-term earnings drivers for the Anodes segment are the magnesium price and demand for water heaters which is a function of housing growth and economic activity. Both of these are out of the control of Magontec. The relatively stable gross profit of the Anodes business is a function of its strong market position, the consequential ability to negotiate effectively with a small number of customers and the fact that 80% of anodes go into the replacement market.

Similarly in the Metals division, which consists of magnesium alloy production and scrap material recycling, the earnings drivers are the magnesium price and the motor vehicle industry.

The metals business is the most volatile as evident in the change in gross profit across both divisions.

**Figure 1: Quarterly gross profit split across the business (A\$m)**



Source: Company

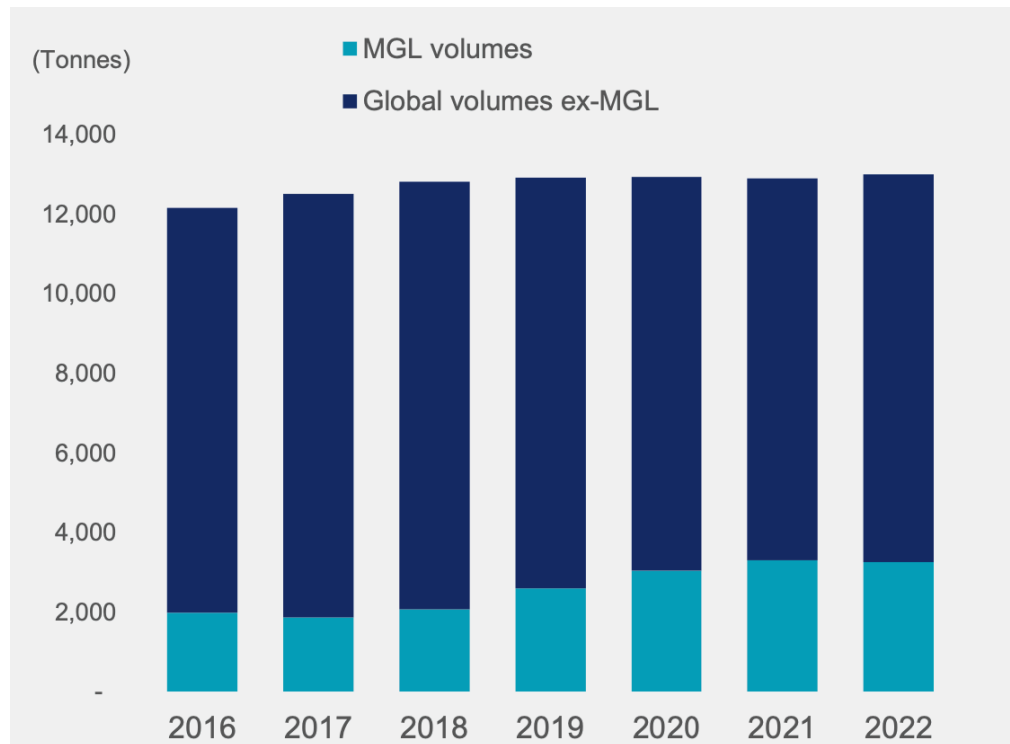
Magontec continues to undertake fundamental improvements in each of these businesses.

### Anodes

Magontec continues to build on its high market share niche position in the anodes space. The strength of its market share in China and Europe is understated when considering Magontec's share on a global basis.

However, the growth in market share over the past 5 years is obvious.

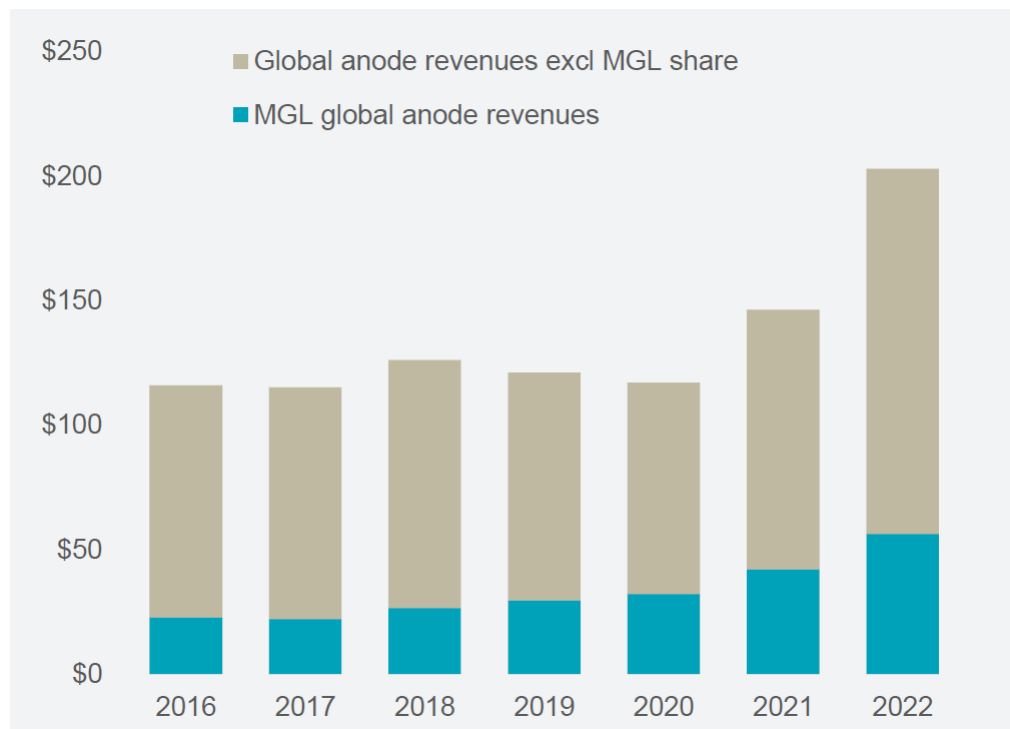
**Figure 2: Global magnesium anode volumes**



Source: Company

More important has been the growth in electronic anodes and Magontec's growing share of this higher margin business.

**Figure 1: Global anode revenues (Mg and electronic) (A\$m)**



Source: Company

We expect Magontec's growth in electronic anodes to continue. Magontec has launched the most recent iteration in powered anode systems for EU and US OEMs, which will strengthen sales in CY23 and beyond. This new product will enable Magontec to compete more effectively in the heat pump

category – an environmentally driven change in hot water heaters supported by government subsidies and environmental incentives in many countries.

The gradual increase in capacity for magnesium anodes in the Xi'an factory to 4,500 metric tonnes per annum means Magontec is the world's largest producer of magnesium anodes at a capacity equivalent to ~25% of global demand.

## Metals Segment

The metals segment consists of a small alloy business in China and a strategically important recycling business across two sites in Europe - Germany and Romania. This business derives 80% of its revenue from the motor vehicle industry.

Like most scrap metal businesses, it is sensitive to the price of the underlying material. When prices were higher, Magontec took the opportunity to develop a reprocessing technology that now recovers 60% of what was previously sent to landfill.

### Qinghai factory

The restart of this facility will transform the profitability of the Metals segment. It is difficult to have an informed view of the likelihood and timing of this occurring. A statement on the Qinghai factory timeline was given by Magontec non-executive director Li Xing Cai, the General Manager of the parent company for Qinghai Salt Lake Magnesium Co (QSLM). The QSLM operates the magnesium smelter complex alongside Magontec's Magnesium alloy cast house. In an interview hosted post AGM, Li outlined the core technology issues which are forcing delays:

- Remediating the dehydration process (core issue undermining the magnesium extraction) – basically resolved
- Electrolysis process – conversion from solid to liquid; chlorine gas needs to meet quality requirements

Li has advised that the process of electrolysis technology testing is expected to be complete by 2H24, including passing the environmental standards that the Chinese government has imposed.

### Outlook

Sales in the magnesium alloy business have an 80% end-market exposure to the automotive industry. Given the high sensitivity to consumer confidence and interest rates, management is expecting lower volumes and more competitive pricing in the Mg alloys business due to higher customer inventories with Q2 weaker than Q1.

## Cash position

We expect that the cash that was consumed by working capital in CY22 will be released over the next 2 years. Management stated that the first quarter cash of \$2m released from a reduction in working capital gives a benchmark to forecast future cash realisation for the remainder of CY23. We estimate that \$10m of working capital will be released in CY23 as a result of the falling magnesium price that we expect to normalise for the year around US\$3,000 per tonne.

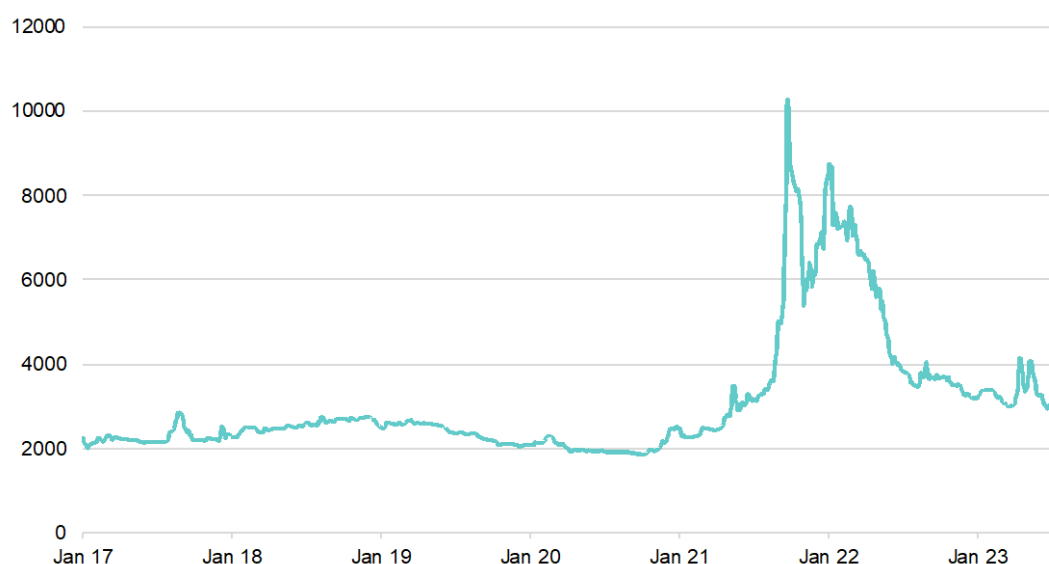
At the AGM earlier this year, the Company pointed toward exploring M&A opportunities with a focus on rational pricing and integration with the existing business, as well as continuing to increase total shareholder returns through dividends.

## Magnesium price

The magnesium price (China) appears to be settling close to US\$3,000. A few months ago, there were announcements that 50% of the magnesium production capacity in the Fugu province was to be closed. We understand that Fugu province represents up to half of all Chinese production. With Chinese production representing ~85% of global production, these closures had the potential to fundamentally drive up the magnesium price. While speculators drove the price higher in the short term, it appears that total production in China remains little changed with the price settling back to where it was prior to the speculation about production closure.

In addition, coal prices continue to soften in China, as do Dolomite prices – both key inputs to the Pidgeon process for magnesium production.

It would also appear that inventory levels in Europe remain well above normal – also contributing to weaker prices. That said, magnesium prices remain at substantial premiums to levels in the years leading up to 2021 when the price skyrocketed.

**Figure 4: Magnesium price – China (US\$)**

Source: Bloomberg

We estimate Magnesium prices to return to an average price of US\$2,500/t by CY25. Lower magnesium prices put pressure on Magontec's earnings, requiring on-going fundamental improvements in business profitability to ensure earnings growth.

## Forecasts

CY22 earnings were supercharged by the high magnesium price and Magontec managed its strong position in both the Anodes and the Recycling industries to maximum benefit. While the first quarter was a strong result, management commentary has indicated weakening performance and expects CY23 to be weaker than CY22.

**Figure 5: Changes to forecasts**

(A\$m, Dec y/e)	FY23e			FY24e		
	Previous	Current	% Chg	Previous	Current	% Chg
Revenue	116.6	106.3	-9%	158.8	127.4	-20%
Gross Profit	21.5	20.5	-5%	21.4	19.0	-11%
Gross Profit Margin	18.4%	19.2%	80 bps	13.5%	14.9%	146 bps
<b>EBITDA</b>	<b>11.3</b>	<b>10.2</b>	<b>-10%</b>	<b>10.9</b>	<b>8.6</b>	<b>-21%</b>
Margin	9.7%	9.6%	-8 bps	6.9%	6.7%	-14 bps
<b>NPAT underlying</b>	<b>5.9</b>	<b>5.1</b>	<b>-14%</b>	<b>5.5</b>	<b>3.9</b>	<b>-29%</b>
Earnings per Share (A\$ cents)	6.9	6.0	-14%	6.5	4.5	-30%
Dividends per Share (A\$ cents)	0.7	0.7	nm	0.7	0.7	nm

Source: MST Access

Note that we now assume Qinghai will restart in the second-half of CY24 (previously first-half), factoring in a degree of uncertainty to this forecast.

## Valuation

We use a sum of the parts valuation methodology for Magontec. This consists of a 12-month forward valuation based on capitalising earnings from the Anodes business using an EV/EBITDA multiple derived from a list of comparable companies which is then discounted by 30%. We use the same valuation of the recycling business (part of Metals division) used in our initiating coverage report which was based on the sale of a magnesium recycling company that was similar to Magontec's European recycling business. We include a \$5m valuation for Qinghai based on a heavily discounted valuation of the business assuming 15% capacity utilisation.

**Figure 6: Sum of the parts valuation**

Business	Valuation methodology	EV (\$m)	Net Debt (\$m)	Equity val. (\$m)	per share (\$)
Anodes	EV / EBITDA multiple (disc comps)	34.3	-2.0	36.3	\$0.43
Recycling	Capacity multiple (recent txn)	11.4		11.4	\$0.13
<b>Total</b>	<b>(fully operating businesses)</b>	<b>45.7</b>	<b>-2.0</b>	<b>47.7</b>	<b>\$0.56</b>
Qinghai	EV / EBITDA at 15% capacity util.	5.0		5.0	\$0.06
<b>TOTAL</b>		<b>50.7</b>	<b>-2.0</b>	<b>52.7</b>	<b>\$0.62</b>

Source: MST Access

Our valuation of the Anodes business is based on the capitalisation of the of Magontec's CY24 earnings using the median multiple of a range of metal processing companies which we discount by a further 30%.

**Figure 7: Valuation of the Anodes business based on discounted comparable EV/ EBITDA**

EV / EBITDA valuation - Anodes		
Comparable companies - median (FY24/FY25)	x	7.2
Discount for company size	%	30%
EV / EBITDA multiple for Anodes	x	5.1
FY24/FY25 EBITDA (incl. 50% of overheads)	A\$m	6.8
Enterprise Value	A\$m	34.3

Source: MST Access

The EV/EBITDA multiple used in respect to the table below is a time adjusted average for a 12-month forward valuation as at 1HCY23.

**Figure 8: Comparable companies**

Valuation		Price (AUD)	MCAP (AUD)	EV (AUD)	EBITDA Margin		EV/ EBITDA		Price / Earnings	
					2024	2025	2024	2025	2024	2025
SGM-AU	Sims	15.56	3,006	3,387	6.8%	6.6%	6.3x	5.8x	14.0x	12.5x
UMI-BE	Umicore	27.76	11,328	12,858	23.5%	22.4%	7.6x	6.9x	15.2x	14.1x
600459-CN	Sino-Platinum Metals	15.43	2,407	2,775	2.0%	2.1%	12.1x	9.8x	17.7x	14.5x
DBG-FR	Derichebourg	5.38	1,419	2,610	9.4%	9.4%	4.3x	4.2x	4.7x	4.1x
SCHN-US	Schnitzer Steel Inds	32.10	1,307	2,031	4.8%	6.5%	9.9x	7.7x	29.2x	20.1x
ERA-FR	Eramet	87.00	4,143	5,384	21.1%	23.8%	3.7x	3.1x	5.7x	3.9x
RS-US	Reliance Steel & Aluminum	285.07	24,802	25,638	13.2%	11.7%	9.6x	10.8x	15.0x	16.9x
<b>Median</b>					<b>9%</b>	<b>9%</b>	<b>7.6</b>	<b>6.9</b>	<b>14.5</b>	<b>13.3</b>

Source: FactSet, MST Access

We have retained the original valuation methodology of the recycling business which was based on a transaction multiple of a European magnesium recycling company in 2019 (refer to initiation coverage report for further details - <https://www.mstaccess.com.au>).

Similarly, we have retained the valuation methodology for MGL's Qinghai business but applied a further 50% discount given the on-going delays and uncertainty around the restart of its supplier, QSLM. Our analysis assumes that QSLM now re-starts production of magnesium in 2H24, and the liquid metal starts being delivered to MGL Qinghai's cast-house in 2024 with initially up to 15,000 tonnes of production of magnesium (total capacity is 100,000 mtpa).

Note that should QSLM fail to deliver molten magnesium to MGL Qinghai, then at some point in the future, we would expect QSLM may be in breach of its agreement. It is not clear what recourse MGL might have to QSLM, however, we note that QSLM owns 29% of the equity of MGL.

## Investment Thesis

MGL operates three magnesium processing businesses with processing plants based in China and Europe. The Cathodic Corrosion Protection (Anodes) segment produces anodes for residential and commercial water heaters in China and Europe which are sold to original equipment manufacturers (OEMs) in China, Europe and the US. The Metals segment has two elements: a magnesium alloy Recycling business in Europe whose customers are motor vehicle manufacturers and Tier 1 suppliers; and a magnesium alloy production business in Qinghai, China sited next to a magnesium plant (QSLM)

from which it will receive molten magnesium once this plant restarts. This plant halted production in late 2019, and it is expected to restart supplying molten magnesium to MGL's Qinghai facility in the second half of CY24.

From a valuation perspective, we consider MGL in three parts: Anodes, Recycling and Qinghai.

## **Anodes and Recycling – aggregate value underpins the current share price**

The Anodes business produces traditional magnesium anodes and electronic anodes that are used in water heaters to prevent corrosion. Volumes show solid stable growth over the past 5 years with MGL having high market share in what is a niche sector. This is a stand-alone business and we have therefore valued it separately on an EV/ EBITDA basis using the average multiple of comparable companies discounted by 30%.

The Recycling business does not report separately, but its high market share as an important supplier to the European and North American markets gives it strategic value. We estimate its value based on the price achieved in 2019 on a capacity based multiple for a smaller but similar business.

## **Qinghai – serious upside but out of MGL's control**

MGL's Qinghai magnesium alloy cast house was designed to be supplied molten magnesium by Qinghai Salt Lake Magnesium Co. Ltd (QSLM). The business is currently loss-making as MGL is sourcing a nominal amount of high cost magnesium to ensure at least some of its customers continued to get supplied. The timing of the restart of QSLM operations is proving difficult to predict with its restart subject to on-going delays.

Qinghai is the source of substantial upside but is wholly dependent on the supply of molten magnesium from QSLM. Should MGL's Qinghai plant achieve 50% capacity utilisation by the end of CY25 (based on product from QSLM), this would add a further \$0.45 per share to our valuation.

We are not aware of the details of the supply and access contract between QSLM and MGL and the potential scenarios should QSLM not meet its contractual obligations to supply magnesium metal to MGL Qinghai's alloy production facility. We note that QSLM has a 29% stake in MGL and the general manager of QSLM has recently been appointed as a non-executive director at Magontec.

## **Risks**

- Failure of the Qinghai cast house to receive the planned magnesium metal
- QSLM magnesium production does not restart or does not produce the contracted level of magnesium metal
- The problems with trucks used to deliver the metal from QSLM to MGL's cast house remain unresolved (notwithstanding that there has been more than sufficient time to fix the problem)
- QSLM divert the magnesium to other customers to an extent that is in breach of the agreement
- MGL loses its licence to operate in the Qinghai province
- Unforeseen operational (including safety) problems at Qinghai, or indeed any of its other processing plants in China, Germany and Romania
- A dramatic deterioration of the competitive environment in one or more of its markets
- A loss of access to capital which is particularly important to fund working capital which increases in line with sharply rising magnesium prices
- We may have underestimated the extent to which demand for structural magnesium in vehicles will offset the decline in demand for magnesium used in engines and drive chains as electric vehicles replace internal combustion engines
- We may have over-estimated the long-term demand for "green" magnesium from the transport industry



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