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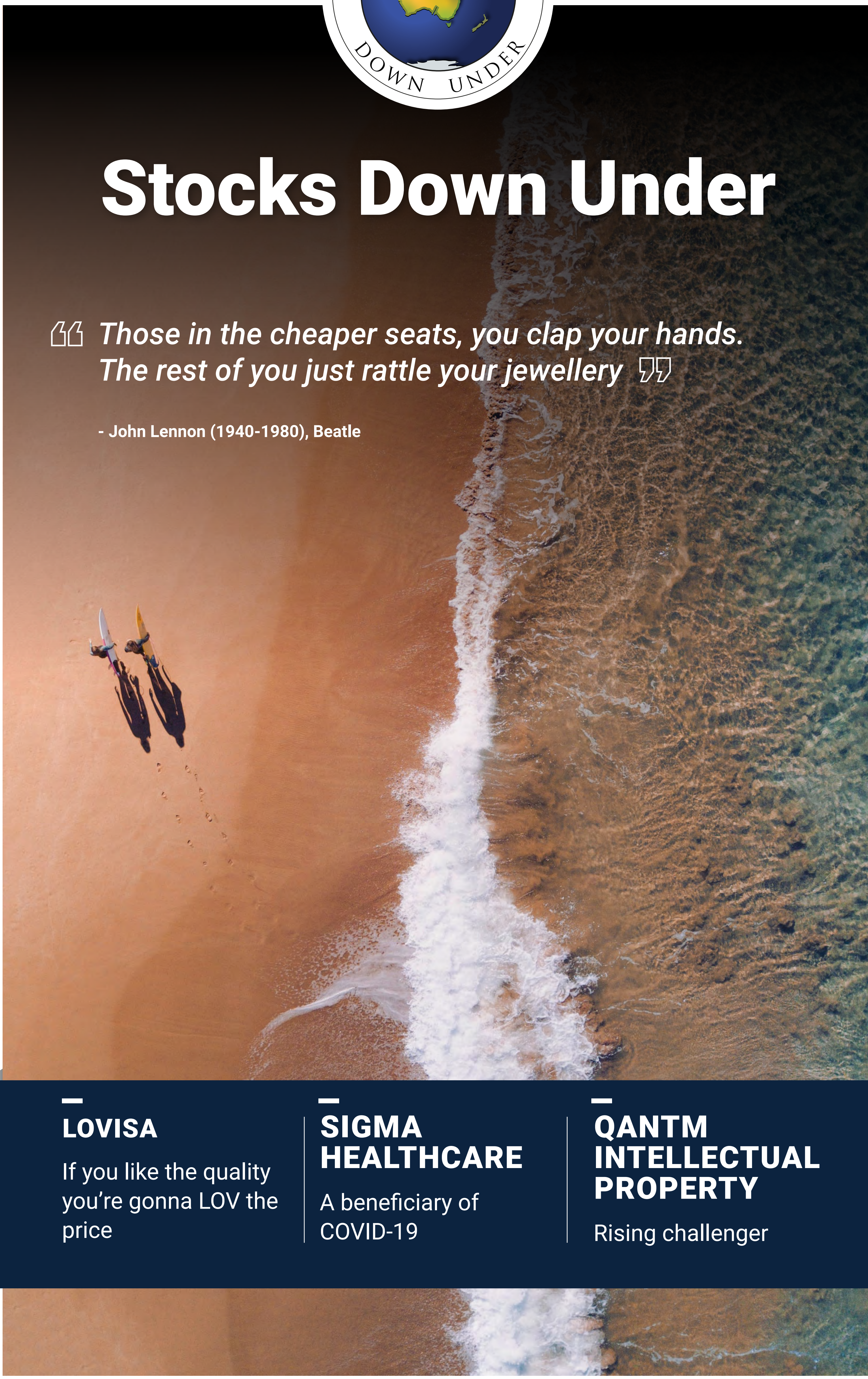

Stocks Down Under

“Those in the cheaper seats, you clap your hands. The rest of you just rattle your jewellery”

- John Lennon (1940-1980), Beatle

LOVISA

If you like the quality you’re gonna LOV the price

SIGMA HEALTHCARE

A beneficiary of COVID-19

QANTM INTELLECTUAL PROPERTY

Rising challenger

LOVISA

If you like the quality you're gonna LOV the price

Stocks Down Under rating: ★★★★

ASX: LOV
Share price: A$ 6.42
Market cap: A$ 672M

Regular viewers of our internet show "Friday Beers with Marc & Stuart" will know that we are big fans of Melbourne-based fashion jewellery retailer Lovisa. The company's low-priced range of jewellery holds strong appeal to a broad range of relatively young consumers. The Corona Crash has taken Lovisa's stock price back down to 2017 levels, which we believe presents an excellent opportunity to get in for people who missed the boat initially.

READ MORE

SIGMA HEALTHCARE

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ASX: SIG
Share price: A$ 0.595
Market cap: A$ 591M

Melbourne-based Sigma Healthcare is a wholesaler and distributor of prescription and over-the-counter products to the Australian pharmacy industry. It also owns several retail pharmacy brands including Amcal, Amcal Max, Discount Drug Store (DDS) and Guardian. The stock has yet to mount a sustained comeback since an accounting scandal and accusations of preferential deals with bigger customers rattled the company a decade ago. However, heightened near-term demand related to COVID-19 and an improved fundamental story may be just what the doctor ordered.

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Share price chart

Source: Tradingview

Lovisa's mission of providing highly affordable, but very fashionable jewellery, is simple and straightforward. Most of its products are priced between $15 and $40 and are marketed like high-fashion products. The company's expansion strategy is equally straightforward. It wants to expand its presence across high-traffic shopping malls in the world's most attractive consumer markets, including the US, north-western Europe, selected countries in Asia and Africa and, of course, Australia and New Zealand.

Things were going very well pre-COVID-19

What was clear from Lovisa's 1HY20 results, released in February, was that the company again performed very strongly on the back of new store openings in particular. Revenues were up more than 22%, to $162.8M, with a gross margin of 78.9%. This was slightly down from 81% the year before due to adverse currency hedging effects. Like-for-like sales grew 2.1%.

Sales in Australia and New Zealand, together accounting for about half of Lovisa's global sales, grew a solid 6.2% driven by a strong performance in online sales and good like-for-like sales growth.

With an additional 49 new stores opened during the half, or 12.5% compared to the 390 stores open at the end of FY19, Lovisa's expansion strategy was right on track. Enter COVID-19.

COVID-19 stopped Lovisa in its tracks

COVID-19 has pulled the rug from under Lovisa's 2HY20 sales. The company initially closed stores in France, Spain, Malaysia, the US and the UK in the first half of March. At the end of March, the company announced that it had also closed all its stores in Australia, New Zealand and South Africa. The only store still open is Singapore, while online sales can continue of course.

Including new store openings in the first few months of 2020, Lovisa currently runs 449 stores globally (including the ones that are now temporarily closed) and was working on new store openings in the current financial year. However, it seems extremely likely that a number of those new store openings will be pushed out. In response to COVID-19, Lovisa recently announced that the payout of its $0.15 interim dividend will be pushed out to the end of September.

Investment case remains unchanged

We consider the current COVID-19 hold up as a temporary spanner in Lovisa's works. Once lockdown restrictions start to get lifted, and footfall returns to shopping malls under social distancing measures, we believe the company's customers will still know where to find value jewellery. Given the changed economic conditions, Lovisa may even be able to attract a consumer cohort that traditionally shopped at somewhat more expensive, competing, stores.

In any case, we believe the company can resume its growth path once things return to the, new, normal, with store openings likely resuming in a few months.

Following an anticipated 4.6% decline in EBITDA to $59.5M in the current financial year, as a result of the COVID-19 fallout, the market is projecting an EBITDA of $74.9m in FY21 and $105.7m the year after. Seen in that light, the current EV/EBITDA multiples of 11.1x and 7.9x for FY21 and FY22 respectively, don't seem very expensive. At $6.42 per share, Lovisa remains one of our favourite Retail plays.

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Share price chart

Source: Tradingview

Retail, wholesale performing well

Sigma Healthcare has joined the ranks of companies having difficulty with forecasting long-term business conditions due to uncertainty surrounding the coronavirus crisis. It has also suspended its FY20 dividend. However, it is among a small group of companies that are expected to benefit from COVID-19 related spending because it has been designated as a CSO-approved medicines supplier and an essential business by the Australian government. On 25 March, it noted that year-to-date sales had increased significantly. Sales volumes from 1 March to 25 March were up 50% over the same period last year and 80% ahead of the company's expectations.

Its pharmacy brand sales had been strong leading into the COVID-19 outbreak. Like-for-like pharmacy sales increased 11.7% in the 12-month period ending 31 January 2020 and member buying compliance was strong. The company has more than 600 members across its pharmacy brands and its pipeline of prospective members is strong. New offerings in the form of the Amcal + Life clinic and WholeLife Pharmacy as well as the launch of the Healthfoods brand have helped drive sales and high customer satisfaction scores.

The pharmacy wholesale business has also experienced solid growth with ongoing revenue up 8.5% in FY20. The sales growth has been well diversified as both individuals and small groups are choosing to partner with Sigma. New customers representing over $180m in annual sales were onboarded in FY20 and few customers were lost. This trend is likely to continue given the strong sales pipeline heading into FY21.

Distribution centre, IT investments driving improved efficiency

Continued momentum in Wholesale will be supported by the new Chemist Warehouse agreement and the extension of the Pharmacy Alliance agreement worth approximately $500m. The 4-year Chemist Warehouse contract for fast-moving consumer goods (FMCG) started November 2019 and implies annual sales of $800m. It includes a second line Pharmaceutical Benefits Scheme (PBS) that provides subsidised prescription drugs to Australians and certain foreign visitors. This will help diversify Sigma's earnings away from regulated PBS customers, which represent roughly half of its earnings.

The company's upgrade of its distribution centres (DC) has generated significant shareholder value. Upgrades in Berrinba QLD, Canning Vale WA, Pooraka SA, and Kemps Creek NSW have been completed and more expansions are planned over the next 18 months. The DC investment program is not only adding capacity but reducing costs and driving operational efficiency gains. The timing of the added space has been fortunate because it has given Sigma the infrastructure to handle high demand stemming from COVID-19 shopping.

Shareholder value has also been driven by Sigma's investment in critical information technology (IT) infrastructure. A new CRM tool was deployed to its salesforce last month to replace a collection of inefficient legacy systems. It is also in the process of upgrading its enterprise resource planning (ERP) system. This will include both public and private cloud solutions through partnerships with United States-based system integration companies Accenture and Infosys.

Sale and leaseback transactions strengthen balance sheet

Sigma has invested approximately $160m in land and buildings over the last four years. It has seen the combined value of these assets increase by more than $100m. It recently entered a series of sale and leaseback transactions to astutely unlock this value at a time of high market uncertainty. The sale-and-leaseback of its new Distribution Centres has had a favourable impact on the company's balance sheet. It bolstered the cash balance giving it the flexibility to pursue other growth opportunities.

The company has also embarked on a business transformation that has the potential to drive continued growth. Organisational changes in sales and marketing related to Project Pivot along with investments in distribution centres and technology are driving efficiency gains across the business.

It has had a strong start to FY21 due to COVID-19 demand and the long-term growth outlook is positive. At EV/EBITDA multiples of 10.2x and 8.7x for the current FY21 and FY22 respectively, we believe Sigma is attractively valued given the projected EBITDA growth of 65% and 17% respectively in both financial years.

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Share price chart

Source: Tradingview

Back in the day, intellectual property law in Australia was practised quietly and privately in partnerships. Then a well-known firm called Spruson & Ferguson chose to go public in 2014 as IPH Ltd (ASX: IPH), a company we wrote about on 27 March. Next came Xenith IP in 2015 and Qantm Intellectual Property in 2016.

The thinking in each case was that the world of intellectual property was now truly global, so firms needed to get big enough to compete internationally or get out. Also, stock in a listed company was perceived to be an easier way to attract and reward the next generation of talent rather than the old-fashioned way of being able to offer a partnership down the track.

Qantm theory

When you talk to investors who know the intellectual property management space, they tend to be dismissive of Qantm. That's mainly because of the May 2017 profit warning and the company's defeat last year in the bidding war to acquire Xenith IP, which was won by IPH.

The May 2017 profit warning was, we think, probably an unintended consequence of the way in which Qantm started its listed life. Its original two firms were Davies Collison Cave (DCC) and FPA Patent Attorneys. DCC was a venerable firm that everyone in Australia involved in intellectual property knew because the name Davies and Collison had been around since before the Great Depression. FPA was the old patent law practice that Freehill Hollingdale and Page, a top tier law firm, had started back in the late 1980s. When Qantm put these two class acts together they became a >$100m a year revenue operation throwing off $25m or so in EBITDA. Nice work if you can get it.

A not-so-hot IPO

Qantm was able to go public in August 2016 with a market capitalisation close to $300m. That transaction, however, was not one people should have invested in, because, of the 66.5 million shares offered to the public at $2.22, only the proceeds of 14.3 million of these went back into Qantm. The rest went to the folks who had built DCC and FPA over the years. Some might unkindly quote Michael Lewis who in Liars Poker described what life seemed to be like for the partners of Salomon Brothers after the firm's sale to Philips Brother in 1981: 'It was as if they said, all at once, "We have our money now, what's next?" An empire. Class. Weekends in Paris. Nights at St James Palace'.

What came next, in May 2017, for Qantm Intellectual Property, was a trading update complaining about how slow business was. The stock promptly fell to $1.13, around the level it is right now.

The Xenith bidding war of 2019 saw IPH pay $192m to get hold of the owner of Griffith Hack, Shelston, Watermark and Glasshouse Advisory, a price that Qantm considered too high. The perception among investors now is that IPH has become the 800-pound gorilla and Qantm remains a mere gibbon, having only managed to make one major acquisition since 2016 – the Malaysian intellectual property company, Advanz Fidelis.

They try harder

So why invest in Qantm now? Well, since January this company has had new leadership, with current CEO Craig Dower having joined Qantm from Xenith, where he was CEO until the merger with IPH. So, it's fair to say that Qantum has a good idea of where the competition is still weak.

Then there's the underlying business itself. Australia as a nation on average come up with about five patentable inventions a day and that means a steady flow of new work to DCC and FPA, who are often top of mind when those inventors need a good attorney. And those inventors have been pretty loyal to DCC and FPA since 2016, as evidenced by the fact that Qantm's underlying revenue in FY19 was $90m and EBITDA $24m.

We expect Qantm's margins to stay strong over time because a lot of what Qantm is doing now is investing internally in systems that will make its professionals more productive.

And there's still room to grow through acquisitions, if not locally then elsewhere in the region where the IP landscape is still evolving (and a Head of M&A will start with the company soon).

Currently for all this you can get Qantm at a P/E of 10.1x forecast FY21 earnings. That's well below the 18.6x that market leader IPH is currently trading at and seems inexpensive to us, and a good price to pay for a strong challenger.

Pitt Street Research Pty Ltd

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