STOCKS DOWN UNDER

24 AUGUST 2020

Stocks Down Under

Doubt kills more dreams than failure ever will.

- Suzy Kassem (b. 1975), American screenwriter and poet

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PROPEL FUNERAL PARTNERS

You can't staple on growth forever

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Stocks Down Under rating: ★★★★

ASX: KGN
Market cap: A$ 2.3BN
Dividend yield: 0.91%

52-week range: A$3.45 / A$22.99
Share price: A$ 21.74

Kogan.com is an internet-based conglomerate headquartered in Melbourne with a portfolio of nine main divisions. From home loans to insurance for your pet to a toy for your child, Kogan.com has something for almost every consumer. Often called the Amazon of Australia, Kogan.com has seen remarkable growth from its main platform, Kogan Retail, which it has driven into expanding into other markets and industries. While COVID-19 has cried 'Havoc' and let slip the dogs of war on many retail companies, due to Kogan.com's purely online nature, COVID-19 could drive Kogan.com's business for years to come.

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Market cap: A$ 208M

52-week range: A$0.080 / A$0.265
Share price: A$ 0.145

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Share price chart

Source: Tradingview

Perfect place and perfect time

After COVID-19 forced everybody indoors for a large part of 2HY20 online shopping exploded, especially with stores where you could get everything in one place. Kogan.com saw an increase in active customers of 35.7% during FY20 on a year-over-year basis and strong growth in their loyalty program as well. Approximately 40% of customers made another purchase within one month during the second half of FY20, another indication of strong customer retention. Even after COVID-19 is long over, especially due to the growth in Kogan.com's loyalty program membership, we believe it is likely this increase in active customers is a permanent one. This strong increase in active users has transferred into high inventory turnover with at least 99% of Kogan.com's inventory, as of 30 June 2020, less than one year old.

From the financial side of FY20's results things looked just as solid. Margin growth accelerated with gross margins increasing 5.3%-point and EBITDA margins increasing 3.1%-point year-over-year. Kogan.com has no long-term debt, with the exception of $500k in lease liabilities. Featuring $146.7m in cash and $112.9m in inventories, $88m (76%) of Kogan.com's total liabilities of $115.6m is trade and other payable liabilities. For

a company that's growing as fast as Kogan.com to have effectively no debt is highly irregular and extremely encouraging.

Kogan is heading towards the light, the light of the future

FY20 was clearly a fantastic year for Kogan.com. However, the question remains, after such an impressive year can Kogan.com perform during FY21? In our opinion all indications point to yes. While the company has declined to provide guidance for FY21 this seems to be a positive indication rather than a negative one. July 2020 EBITDA was slightly greater than $10 million, when considering how FY20 EBITDA was $49.7m, this is a rather significant result. It seems that the refusal to issue guidance is not due to hardship, but strong success.

It is important to remember that COVID-19 has reappeared in Australia during FY21 and many people are still working from home for the foreseeable future. Victoria is in lockdown and Sydney has a current mask advisory. Even in areas of the county where people are returning to their daily lives it seems unlikely that they will rush back to the large shopping centres as even before COVID-19 the trend was shifting towards online retail. As more people are exposed to Kogan.com due to COVID-19, more customers are likely to make the switch.

Are acquisitions in Kogan.com's future?

Before we dive into this, we must highlight the fact that this part is educated speculation on our part, based on the past actions of Kogan.com. Back in 2016, after Dick Smith collapsed, Kogan.com bought the business and with significant success shifted the company to purely online and relaunched the brand. As many retailors face bankruptcy due to COVID-19 it is worth asking if Kogan.com will repeat its Dick Smith strategy. Capital and cost are not much of a concern as Kogan.com has a balance sheet as pure as undriven snow and with rock-bottom interest rates Kogan.com is in a fantastic position to continue to expand its portfolio of brands and companies without any credit or dilution risk for shareholders. An individual, or series of, strategic acquisitions at this time could increase Kogan.com's growth farther than we are already expecting and makes sense with the company's current financial situation. While there is the risk of Kogan.com losing sight of its original mission, based on the company's current and past performance, Kogan.com clearly knowns when to cut its losses and when to drive home a winner. Therefore, this risk seems within reason for now.

Kogan.com demands a premium

On 14 February 2020, we rated Kogan.com two stars due to its January business update that cautioned revenue growth was going to be slower than previously thought. Well, we got that one wrong.

The fact is, Kogan.com trades at a significant premium to the broader market due to its higher than average growth rate. COVID-19 has really changed the game for Kogan.com and concerns that the era of over 20% annual revenue growth was coming to an end have been replaced with confidence in a new period of rapid expansion.

Kogan.com is currently trading at an EV/EBITDA ratio of 45x with a return on assets of 12.9% and a return on equity of 24.9%. FY20 EBITDA beat the consensus estimates by approximately 2% and, as mentioned above, current comments by management are highly encouraging.

With COVID-19 still causing concern around Australia, this upcoming holiday season should be a very interesting time for Kogan.com. Therefore, even trading at an EV/EBITDA ratio of 45x, which we believe is well-supported by the expected 65% EBITDA growth in FY21, we believe the only possible rating for Kogan.com at this time is four out of five stars.

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Share price chart

Source: Tradingview

If you've looked at the oil and gas space as an investor at any time in the last 12 years you would doubtless have heard people talking excitedly about a place called 'Eagle Ford'. Actually, what they were referring to was a shale formation in Texas whose massive oil riches were first realised by a Houston-based company called Petrohawk Energy in 2008, and where other companies subsequently flooded in to south and central Texas looking to tap the same formation. The Eagle Ford Shale made a lot of people rich over the next few years.

In 2011 Petrohawk was sold to Australia's BHP for US$12bn, while in early 2014 an ASX-listed company called Aurora Oil and Gas, which had been an early and astute player in the Eagle Ford, was sold to the Calgary-based Baytex Energy for a cool A$2.6bn. Even after you back out the fact that the Canadians assumed debt of A$800m, that's not a bad return on the A$28m market cap at the time of Aurora's 2005 IPO. The timing of that transaction was exquisite, because West Texas Intermediate was over US$100 a barrel at the time, but it June 2014 it crashed and by early 2016 it was under US$30 a barrel.

The Aurora Effect

We think the afterglow of the Aurora payday is one reason Helios Energy went from 2 cents at the time of its August 2017 back-door listing on ASX to a peak of 26 cents in September 2019. The connection is Neville Henry and Peter Allchurch, two veteran oilmen from Australia who, over a decade ago, introduced Aurora to its original Eagle Ford project. More recently they introduced Helios Energy to its current projects in Texas, Presidio and Trinity. Their initial involvement was enough to attract some strong initial interest on ASX.

It helped that Helios made an oil discovery at Presidio in mid-2018. Texas' Presidio County is in western Texas on the Mexican border. It's a little distant from the usual West Texas oil action, being 250 miles southwest of Midland, the unofficial capital of the world-famous Permian Basin. That said, the major oil refinery that Marathon operates at El Paso is only 190 miles northwest. Helios' 2017 backers identified 6,000 acres that the mapping had suggested was prospective for oil in the Eagle Ford as well as other formations, and the company was earning 70% with three vertical wells. It was wildcat territory, but by July 2018 Helios had found what it had come for when it fracked the first well, called Quinn Creek 141.

A nice second well

Right above the Eagle Ford Shale in Presidio was a formation locally called the Ojinaga, because of the Mexican town of that name just across the Rio Grande from Presidio County. Elsewhere in Texas rocks of the same age as the Ojinaga are called the Austin Chalk, and that formation has been known since the 1970s to be a good oil producer. It was the lower Ojinaga that flowed oil when Quinn Creek 141 was subjected to a single-stage frack in mid-2018 and got Helios' management particularly excited, because the porosity and permeability of the formation were better than what you'd find in the best of the Eagle Ford.

Last year's Presidio 141 #2 well, which was nearby the Quinn Creek 141 discovery well, was the reason Helios stock got to 26 cents, because when a 1,400 lateral leg from this well into the lower Ojinaga was fracked, the oil flows were vigorous. Now you know why Helios has expanded its leases in Presidio County to around 86,000 acres.

Be cautious – this is an early-stage company

The thing about Helios and Presidio is that this company doesn't seem to take investor relations as seriously as we think it should. There hasn't been a corporate Powerpoint presentation in a long while. And when you visit heliosenergyltd.com, go to the Projects button at the top, then click on the page describing Presidio, and the practised eye will see that the page was written before Presidio 141 #2 was spudded, which was April 2019. $200m ASX-listed companies shouldn't make mistakes like that.

Presidio is a still a very early stage project. Many more wells are going to have to be drilled and so far we only have a single lateral. Sure, wildcat oil discoveries a little outside the traditionally interesting Permian Basin counties will attract attention, but it will be some time before we really know how well Helios has done in Presidio.

More importantly, there are plenty of other valuable US oil and gas plays available for a fraction of the cost of this one. Consider, for example, Australis Oil and Gas (ASX:ATS), which Aurora's old management team founded to go after the Tuscaloosa Marine Shale (TMS), onshore Louisiana and Mississippi. It has close to 40 operated wells in the TMS core and yet you can currently get this gem for less than A$30m. Sure, if WTI goes to US$60 in the medium term it could carry Helios with it, but we'd be cautious. Two stars from us.

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Share price chart

Source: Tradingview

COVID-19 is a net negative for Propel Funeral Partners

Propel Funeral Partners will present its FY20 report before the market opens on 25 August 2020 and it should be an interesting 2HY20 report. COVID-19 has taken its toll on the world, stretching even to the funeral industry. COVID-19 is overall a net negative for Propel Funeral Partners. The restrictions on the number of guests mean the company cannot provide the same number of services and, therefore, the cost of each funeral has decreased.

Due to the restrictions imposed on the number of attendees for funerals between March and April, year-over-year average revenue per funeral decreased 10% during the same period. Since restrictions have mostly been eased since then, revenue per funeral has rebounded 8% from April to May. While overall volume of funerals has increase by approximately 1% during the FY20, according to guidance released in June 2020, this decrease in the average cost of a funeral will continue to put pressure on the company's already decreasing margins.

While the total number of COVID-19 cases in Victoria appears to be stabilising, there is still the risk that the rest of Australia could see a resurgence of new infections. This would be an overall net negative for Propel Funeral Partners as we would likely see restrictions returned and once again the average amount that the company can charge per funeral will decline.

Additionally, while the increase in cases in New Zealand has so far been successfully contained, it is undeniable that COVID-19 has returned to New Zealand. And therefore, the risk of an increase in restrictions on funerals has risen. While it may seem counter-intuitive, an increase in cases of COVID-19 in both New Zealand and Australia would be a net negative for the revenue and especially the EBITDA outlook of Propel Funeral Partners.

Growth by acquisition

During the first half of FY20, on a year-over-year basis, revenue increased by $9.9m. However, in August 2019 Propel Funeral Partners acquired Gregson & Weight, adding $12m in revenue. Additionally, in October 2019 the company acquired Grahams Funeral Services in New Zealand, adding NZ$2.7m in revenue. Since its IPO in 2017, Propel Funeral Partners has spent approximately $124.6m on acquisitions to add $49.4m in revenue. These acquisitions, the majority of which took place in Australia, are the main reason why Propel Funeral Partners has grown its Australian market share from 1.2% in 2015 to 6.3% in 2019.

The balance sheet is stable, for now

Total borrowings as of 31 December 2019 stand at approximately $67.3m, increasing from approximately $13.5m on 30 June 2019 due to the need to borrow for acquisitions. As of 31 December 2019, the company had $82.9m in undrawn debt facilities and approximately $6.7m in cash. While the majority of Propel Funeral Partners' debt won't come due until 2022, net cash from operating activities for 1HY20 was $7.6m, a year-over-year increase of approximately 6.4%. The rate and increase of operating cash flow is not enough to properly cover the rate of borrowings and we believe this means there is high risk to investors of significant dilution in the next couple of years.

Growth by acquisition can work, but only if you grow

Propel Funeral Partners has continued along its strategy of growth by acquisition and the issue is they can't afford to stop. While their acquisitions have increased revenue by $49.4m since their IPO in November 2017, their total revenue increased from approximately $64m during 2017 to approximately $105m during 2019. Therefore, Propel Funeral Partners' revenue has decreased by approximately $8m since the company's IPO excluding acquisitions. The majority of these acquisitions have been funded by debt, not operating cash flow, and that strategy won't be able to change without sacrificing the growth in revenue, earnings before interest taxes depreciation and amortisation, and net profit after tax. This forces us to give Propel Funeral Partners only a two-star rating.

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